

**UNIVERSITY OF THE WESTERN CAPE**

**DEPARTMENT OF ECONOMICS**



**UNIVERSITY of the  
WESTERN CAPE**

**ECONOMIC APPRAISAL OF CHANGES TO THE SOUTH AFRICAN  
TAX SYSTEM SINCE 1990**



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**Research report presented in partial fulfilment of the requirements for the degree of  
Master in Economics in the Faculty of Economics and Management Science, University  
of the Western Cape**

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**January 2014**

## **DECLARATION**

I hereby declare that “Economic appraisal of the South African Tax system since 1990” is my own work, that it has not been submitted before for any degree or assessment in any other university, and that all the sources I have used or quoted have been indicated and acknowledged by means of complete references.

.....

Elizabeth Jaria Ndofula

30 January 2014



## ACKNOWLEDGEMENTS

I thank God first and foremost for the opportunity to conclude this dissertation.

I would like to express my gratitude to all those who have been directly or indirectly involved in my dissertation.

My deepest gratitude to my supervisor, Mrs Elizabeth Stoltz, for the excellent guidance, caring, patience and support she has provided in finalizing this dissertation; her contribution has been priceless.

I would also like to thank my parents and family for their endless support.

Last, but not least, I would like to thank my colleagues and friends for their moral support through the journey.



## **ABSTRACT**

### **ECONOMIC APPRAISAL OF CHANGES TO THE SOUTH AFRICAN TAX SYSTEM SINCE 1990**

Countries reform their tax systems to improve economic and administrative efficiency, the impact on income distribution and their revenue-raising capacity. Globalisation has also affected the fiscal autonomy of countries and resulted in the reality of tax competition.

The South African tax authorities have made significant changes to the tax system in over the past 20 years. The first phase occurred after the publication of the Margo Commission's report in 1987 and the second phase followed the work done by the Katz Commission since 1996. The objectives of the reforms included the improvement of tax administration and collection, a re-evaluation of the efficiency and equity aspects of the different taxes, the broadening of the tax base, and most important, to bring the South African tax system in line with changing international tax practise.

The main objectives of this study are to give a descriptive overview of the reforms, to investigate the economic rationale behind the reforms and to answer the question of whether the objectives of the reforms were actually achieved.

The study fills an important void in the South African literature as it is the first comprehensive overview of the tax reforms since the 1990s. The nature of the study is qualitative and investigative. An overview of the theoretical literature is presented together with some evidence from developing countries. To determine whether the objectives were achieved, descriptive statistics are presented using secondary data from South African Revenue Service (SARS); National Treasury, the Organisation for Economic Co-operation and Development (OECD) and the South African Reserve Bank (SARB).

The main findings are that the establishment of SARS contributed significantly to the administrative efficiency and revenue-raising capacity of the tax system. The taxing of fringe benefits under the personal income tax, the introduction of capital gains tax (CGT) and the residence-based principle contributed to the broadening of the tax base. The decrease of marginal rates of personal income tax (PIT) to be more in line with the rate on company income decreased the possibility of tax arbitrage. The phasing out of the secondary tax on companies together with the decrease of the rate of company income tax (CIT) increased the

attractiveness of South Africa for capital-exporting countries. Significant tax relief to middle- and lower-income earners over various years improved the equity impact. However it did not improve the position of the really poor, who are not liable for PIT. The increasing contribution of value-added tax (VAT) compensated to the decreasing contribution of trade taxes; the fact that the VAT rate has stayed constant, since 1993 is an indication of the unpopularity of the tax.



# TABLE OF CONTENTS

<b>DECLARATION</b> .....	<b>I</b>
<b>ACKNOWLEDGEMENTS</b> .....	<b>II</b>
<b>ABSTRACT</b> .....	<b>III</b>
<b>TABLE OF CONTENTS</b> .....	<b>V</b>
<b>LIST OF TABLES</b> .....	<b>VII</b>
<b>LIST OF FIGURES</b> .....	<b>VII</b>
<b>LIST OF ABBREVIATIONS</b> .....	<b>VIII</b>
<b>CHAPTER ONE: INTRODUCTION</b> .....	<b>1</b>
1. 1 PROBLEM STATEMENT .....	1
1.2. RESEARCH QUESTION .....	4
1.3. OBJECTIVES OF THE STUDY .....	4
1.4 DELIMITATIONS .....	4
1.5 METHODOLOGY AND DATA .....	4
1.6 ORGANISATION OF THE STUDY .....	5
<b>CHAPTER TWO: THEORETICAL AND EMPIRICAL LITERATURE</b> .....	<b>6</b>
2.1. INTRODUCTION .....	6
2.2. THEORETICAL LITERATURE .....	6
2.2.1. <i>Economic Efficiency</i> .....	6
2.2.2 <i>Administrative Efficiency</i> .....	8
2.2.3 <i>Equity</i> .....	10
2.2.4 <i>Flexibility</i> .....	12
2.2.5 <i>Political Responsibility</i> .....	13
2.2.6 <i>Institutionalisation of tax reforms</i> .....	14
2.3 EMPIRICAL EVIDENCE ON TAX POLICY IN DEVELOPING COUNTRIES .....	15
2.3.1 <i>Special Features and Constraints of Tax Systems and Administration</i> .....	15
2.3.2 <i>Factors Determining Tax Changes in Developing Countries</i> .....	18
2.3.2.1 Democratization .....	18
2.3.2.2 Declining aid flows .....	20
2.3.2.3 Globalisation .....	21
2.4 SUMMARY .....	24

**CHAPTER THREE: AN ECONOMIC APPRAISAL OF THE CHANGES TO THE SOUTH AFRICAN TAX STRUCTURE SINCE THE 1990S ..... 25**

3.1 INTRODUCTION ..... 25

3.2 CHANGES TO THE TAX SYSTEM: 1990 - 2010 ..... 25

    3.2.1 Phase One: 1987 - 1994..... 25

        3.2.1.1 Income taxation..... 25

        3.2.1.2 Indirect taxes ..... 28

    3.2.2 Phase Two: Katz Commission - 2010..... 29

        3.2.2.1 South African Revenue Services ..... 30

        3.2.2.2 Income taxes ..... 31

        3.2.2.3 Indirect taxes ..... 40

        3.2.2.4 Tax treaties ..... 43

3.3 ECONOMIC APPRAISAL OF THE CHANGES TO THE SOUTH AFRICAN TAX SYSTEM BETWEEN 1990 - 2010..... 43

    3.3.1 Revenue Raising..... 43

        3.3.1.1 Total tax revenue..... 43

        3.3.1.2 Components of total tax revenue..... 45

    3.3.2 Administrative Efficiency ..... 47

        3.3.2.1 Contribution of SARS ..... 47

        3.3.2.2 Evasion, avoidance and penalties ..... 48

        3.3.2.3 Administrative costs..... 49

        3.3.2.4 Tax compliance and taxpayer morale..... 50

    3.3.3 Economic Efficiency..... 50

        3.3.3.1 Broadened tax base ..... 50

        3.3.3.2 Income taxes ..... 51

        3.3.3.3 Indirect taxes ..... 56

    3.3.4 Equity Considerations..... 57

        3.3.4.1 Income taxes ..... 57

        3.3.4.2 Indirect taxes ..... 59

    3.3.5 Macroeconomic Considerations ..... 61

        3.3.5.1 Total tax burden ..... 61

        3.3.5.2 Foreign direct investment..... 62

        3.3.5.3 Economic growth ..... 62

3.4 SUMMARY ..... 63

**CHAPTER 4: GENERAL CONCLUSION..... 64**

4.1 CONCLUSION ..... 64

4.2 RECOMMENDATIONS ..... 65

**REFERENCES ..... 67**

## LIST OF TABLES

TABLE 3.1 RATE OF NOMINAL TAX ON COMPANIES, 1990 - 1994 .....	27
TABLE 3.2 MARGINAL TAX RATES IN SOUTH AFRICA, 1990/91 - 2009/10 .....	32
TABLE 3.3 COMPARING TOP MARGINAL TAX AND COMPANY TAX RATES, 1990 - 2010.....	34
TABLE 3.4 RATE OF NOMINAL TAX ON COMPANIES, 1990 - 2010 .....	36
TABLE 3.5 COMPONENTS OF TOTAL TAX REVENUE (PIT, CIT & STC) 1994 - 2010.....	45
TABLE 3.6 COMPONENTS OF TOTAL TAX REVENUE (VAT, FUEL, CUSTOMS & EXCISES) 1994 - 2010 .....	46
TABLE 3.7 COMPARING TOP MTR AND COMPANY TAX RATES 1990 - 2010 .....	53
TABLE 3.8 TOP COMPANY RATES FOR THE UNITED KINGDOM, UNITED STATES, GERMANY AND SOUTH AFRICA .	54
TABLE 3.9 TAX REVENUE AS % OF GDP.....	61

## LIST OF FIGURES

FIGURE 3.1.TOTAL TAX REVENUE IN SOUTH AFRICA FROM 1994 - 2010 .....	44
FIGURE 3.2 OPERATING COST AS A % OF TAX REVENUE .....	49





## LIST OF ABBREVIATIONS

CBO	Congressional Budget Office
CEEPA	Centre for Environmental Economics and Policy in Africa
SAPIA	South African Petroleum Industry Association
CGT	Capital Gains Tax
CIT	Company Income Tax
COSATU	Congress of South African Trade Unions
FDI	Foreign Direct Investment
GDP	Gross Domestic Product
GNP	Gross National Product
MIDP	Motor Industry Development Programme
MTR	Marginal Tax Rate
OECD	Organisation for Economic Cooperation and Development
PIT	Personal Income Tax
RSA	Republic of South Africa
SARB	South African Reserve Bank
SARS	South African Revenue Service
STC	Secondary Tax on Companies
VAT	Value-added Tax
WTO	World Trade Organization

# CHAPTER ONE

## INTRODUCTION

### 1. 1 PROBLEM STATEMENT

All over the world developed and developing countries adapt their tax systems over time to improve their overall performance according to conventional tax norms, and also in accordance with changing international tax policy and practise.

The rationale for these reforms can be contextualized into the primary objectives of taxation in any particular economy as identified by Newman (1952, p.2). The revenue-raising objective of taxation aims at raising sufficient funds to finance the government expenditure programmes. The stabilization objective sees taxation used in a flexible manner as a tool, together with expenditure and borrowing, to achieve the stabilization of national income and employment, smoothing out fluctuations in economic activity. In addition, taxation is used to achieve a more equitable redistribution of income across income groups with different levels of income. Tax systems are also reformed to improve the economic and administrative efficiency of existing tax systems (Hageman, Jones & Montador, 1988 p.187-197). Through regular reforms, a country can work towards a more optimal tax structure to suit the demands of the particular economy.

Furthermore, in the current globalised world with relatively free mobility of capital and labour, tax competition is a reality and especially in high income developing countries who lose skilled labour and capital to low-tax jurisdictions (Mohapatra, Moreno-Dodson & Ratha, 2012, p.4). It has therefore become necessary for developing countries to bring their tax systems in line with changing international tax practise. According to Bird (2007, p.2), "...developing countries exist in a complex and changing international environment, and tax outcomes in many of these have been affected, sometimes adversely, by globalisation". Tax policy and practise in developing countries have special features, such as that the income base is often very narrow (Tanzi & Howell, 2000, p.308), and often face serious constraints, such as lack of administrative capacity (Black, Calitz & Steenekamp, 2005, p.146).

The South African tax authorities have also made significant adjustments to the tax system in recent years to improve the performance of the tax system and to adapt to the demands of globalisation. Since the 1990s two specific phases of tax reform are of note, following the

recommendations of the Margo Commission (1987) and of the Katz Commission (1994) (Koch, Schoeman & Van Tonder, 2005, p.193).

The first phase of tax reforms, after the publication of the Margo Commission's report in 1987, was a very challenging period in the history of the South African economy – a period of sanctions and disinvestment. During this period the financial account of the balance of payments was negative (Freytag, 2008, p.33) and this brought its own fiscal challenges which had serious implications for tax revenue. There was massive business disinvestment and inflation was relatively unstable, the country experienced increasing brain drain and marginal tax rates (MTR) on personal income were very high (Black, Calitz & Steenekamp, 2005, p.154). In addition there was strong international pressure against apartheid (Koch, Schoeman & Van Tonder, 2005, p.194). For these reasons the Margo Commission (Chairman: Judge Cecil Margo) was appointed to investigate the tax system to alleviate the fiscal challenges faced at the time. The reform considered the restructuring of the existing tax structure that was hindering economic development by using a base-broadening philosophy. It aimed at creating jobs, reducing brain-drain, improving tax compliance and morality, stimulating capital formation, encouraging immigration and promoting entrepreneurship (Black, Calitz & Steenekamp, 2005, p.154).

To achieve these aims the major reforms following the recommendations of the Margo Commission were the introduction of Value Added Tax (VAT), the decrease in the company tax rate and the introduction of the Secondary Tax on Companies (Black, Calitz & Steenekamp, 2005, p.154). Especially significant was the gradual elimination of tax-deductible expenditures and special incentives (Manuel, 2002, p.8) to protect the tax base and enhance economic efficiency by minimising distortions, and to decrease the opportunities for tax evasion and avoidance, hence decreasing the tax gap at that time (Manuel, 2002, p.3).

The second phase of tax reform followed the work done by the Katz Commission after 1996, which was the first tax commission after the establishment of the new democratic government led by the African National Congress (ANC). It is noteworthy that Fjeldstad and Rakner (2003, p.1) mentioned democratisation as one of the factors why countries embark on significant changes to their tax systems. The new democratic government of South Africa had the challenging tasks of constructing a dynamic and modern economy to integrate the country into the global economy; of developing appropriate policies to restructure government expenditure towards social services and to develop a macroeconomic framework that would

stimulate investment and economic growth (Manuel, 2002, p.2). According to Bird (2007, p.5) it was also important to focus on their political survival.

During that period the Katz Commission became aware that the fiscal burden on taxpayers was too high and it had to be corrected by decreasing MTRs on individual income and nominal rates of corporate income tax, improving revenue collection and expanding the tax base (Black, Calitz & Steenekamp, 2005, p.154). As a measure for increasing tax revenue, the Katz Commission policy focused on increasing economic growth and other interventions and ruled out increasing VAT rates (Katz Commission, 1994, p.11). The objectives of the reform included improving tax administration and collection, a re-evaluation of the efficiency and equity aspects of the different taxes (Katz Commission, 1994, p.11) and, most important, the broadening of the South African tax base during this period (Manuel, 2002, p.5).

An important institutional reform during this period was the establishment of the South African Revenue Service (SARS) with the aim of improving administrative efficiency and to enhance the revenue-raising capacity (Manuel, 2002, p.3). Another important reform during this period was the introduction of the residence-based principle in 2001 as recommended by the Katz Commission, (1997, p.9) to broaden the tax base. Special provisions were also made for small business to stimulate labour intensity of production and job creation. These tax reforms, guided initially by the Katz Commission and afterwards by SARS, have led to more efficient tax collection and produced impressive increases in total tax revenue over many years showing that the tax base has broadened and tax compliance has improved in such a way that it exceeded budget estimates. This allowed for widespread tax relief to individuals and companies (Manuel, 2002, p.4). Economic efficiency of the system has improved over the years by reforms such as the taxation of fringe benefits and the introduction of the capital gains tax (CGT). The latter also enhanced the horizontal as well as vertical equity of income taxes (SARS, 2011, p.1). Furthermore, regular adjustments to the threshold of individual income tax have released the poorest from paying tax. Since the 1990s South African tax authorities have also made significant improvements to align tax policy with international tax practice.

However, from a thorough search of the literature it appears that no study has yet been done to critically appraise the extent to which the tax reforms in South Africa since the 1990s have achieved the intended goals. This study intends to fill this void. Tax reform in South Africa is also a very topical issue following the appointment of a new tax review committee in 2013

(South Africa, Ministry of Finance, 2013, p.1) and especially considering the fiscal impact of the global recession.

## **1.2. RESEARCH QUESTION**

To what extent have the intended objectives of tax reforms in South Africa since the 1990s been achieved?

## **1.3. OBJECTIVES OF THE STUDY**

The study has the following objectives in order to answer the research question:

1. To present an overview of relevant theoretical literature as the foundation for the study on tax policy in south Africa;
2. To explore the empirical literature on tax changes in developing countries, with a specific focus on special features of, and constraints facing, these countries, as well as on the factors behind the policy adjustments;
3. To present an overview of the changes to the South African tax structure following the work of the Margo and Katz Commissions and to explain the rationale behind these in terms of the theoretical and empirical overview; and
4. To investigate whether the intended objectives with the changes to the South African tax structure were achieved in practice.

## **1.4 DELIMITATIONS**

The study covers the period from the implementation of the recommendations of the Margo Report, from 1990 to 2010.

## **1.5 METHODOLOGY AND DATA**

The nature of the study is qualitative and investigative. According to Creswell (2003, p.182) qualitative research is fundamentally also interpretative. As such, the study does not aim to prove any hypotheses, but rather to interpret the data in a manner that facilitates the ability to derive meaningful conclusions that may lead to further questions to be researched (Cooper, Potter & Dupagne, 1994, p.55). A literature review presents an overview of the theoretical and empirical literature.

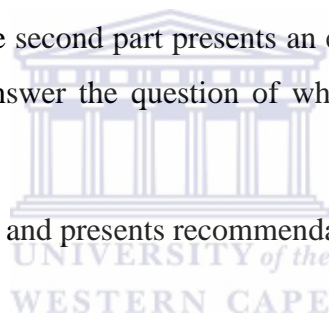
Secondary data was used to present some descriptive statistics on the economic impact of the most important changes to the South African system since the 1990s. Data was sourced from institutions such as SARS, the National Treasury, the Organisation for Economic Co-operation and Development (OECD) and the South African Reserve Bank (SARB).

## **1.6 ORGANISATION OF THE STUDY**

Chapter Two presents a review of the theoretical and empirical literature. It first explains the meaning and relevance of the norms for good taxation and then explores features of tax systems of developing countries as well as the factors behind changes to the tax structures of those countries.

Chapter Three focuses on the South African situation. The first part describes changes to the South African tax system following the work of the Margo and Katz Commissions. It also explains the rationale behind the specific tax changes in the context of the theoretical norms as discussed in Chapter Two. The second part presents an economic appraisal of the changes to the tax system and tries to answer the question of whether policy makers achieved the intended objectives.

Chapter Four concludes the study and presents recommendations arising from it.



## CHAPTER TWO

### THEORETICAL AND EMPIRICAL LITERATURE

#### 2.1. INTRODUCTION

This chapter presents the theoretical framework on the achievements of tax policy and practise in recent years in South Africa. It discusses, in Section 2.2, the conventional norms of a good tax system. These are relevant for this study as countries make tax changes to enhance the performance of their tax systems according to these norms. Section 2.3 focuses on the special features of taxation in developing countries as well as on some factors that were behind the reforms in these countries.

#### 2.2. THEORETICAL LITERATURE

The theoretical literature mentions four conventional norms that a good tax system should adhere to: it should promote a more equitable distribution of income; it should be economically and administratively efficient; and it should be flexible to be able to be adjusted according to the changing economic circumstances. Stiglitz (2000, p.458) added political responsibility as an additional norm, and Bird (2007, p.56)<sup>1</sup> added 'institutionalisation' as a further requirement for tax reform.

The following sub-sections provide a descriptive overview of the meaning and relevance of these tax norms.

##### 2.2.1. Economic Efficiency

An economically efficient tax system is one where the distorting effects of taxes on the choices of decision-makers are minimized, or when the excess burden is as small as possible (Black *et al.*, 2011, p.167). Although all taxes create a burden in the sense that they decrease the real income of taxpayers, they cause an additional or excess burden when they distort the decision-making of producers and consumers.

The factors that determine the magnitude of the excess burden are the elasticity of demand and the level of tax rates (Black *et al.*, 2011, p.188). If the demand for a good is elastic, then an increase in the price will distort the consumer's preference to buy the good, so that the

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<sup>1</sup> Joseph Stiglitz and Richard Bird are international experts on tax policy and reform.

higher the price the less is demanded of the good. The consumer may decide to substitute this good with another. The opposite is true if the demand is relatively inelastic. Second, some excess burden is generally inevitable because not all goods and services are taxable, for example leisure.

For a tax to be efficient, tax rates need to be set in a way that the percentage reduction in quantity demanded of each commodity is the same whether the goods are related or not. This is because the excess burden is a consequence of distortions in quantities and not in prices. This is also known as the Ramsey or inverse elasticity rule (Rosen & Gayer, 2007, p.356). For goods that are unrelated in consumption, economically efficient taxing is one where taxes are inversely proportional to the elasticity of demand. In other words, tax rates can be set higher for goods that have an inelastic demand (such as toilet paper), and lower for goods whose demands are relatively elastic, such as in the case of motor vehicles and furniture. In this way economic decisions are distorted as minimally as possible. Tax rates should be set in a way that increases in the rate should cause as little excess burden as possible. Low tax rates on a large number of goods and services will produce smaller excess burdens and more tax revenue than higher tax rates on fewer goods and services that yield the same amount of revenue. This proposes that broad-based taxes like income taxes and value added taxes are more efficient (Black, Calitz & Steenekamp, 2005, p.144).

In the theoretical sense, an efficient tax system should not have an effect on the economic decisions of people, i.e. what to buy or to invest or how much work to do, if all resources are optimally allocated. In other words, it should be neutral. However, in reality markets are imperfect and an optimal allocation of goods and services that would leave consumption and investment decisions neutral is the exception rather than the rule (Black, Calitz & Steenekamp, 2005, p.140). If taxes are neutral, it makes the system simpler, avoids unfair discrimination between different taxpayers in the economy. Nevertheless, neutrality does not necessarily mean that there will be no distortions in the economy and it may be efficient to differentiate between various activities for purposes of taxation (Rosen & Gayer, 2007, p.354).

There is a case for tax exemptions, where socially beneficial behaviour needs to be promoted by society. These include spending on research and development and pension savings. These cases require a thorough analysis of the advantages of departing from neutrality and of the shortcomings of complicating the tax system. Thus, the motivation for deviating from



neutrality should be really high and have clear and fair justification (Mirrlees *et al.*, 2011, p.472).

The case of negative externalities presents a good example, where the actions of one party impose a cost on the other party for which the latter is not compensated (Black, Calitz & Steenekamp, 2005, p.37). An environmental tax on a firm that exerts a lot of air pollution is not distortive but enhances economic efficiency. Pure economic rents for example, can be differently taxed devoid of economic distortions, as a tax on excess return on capital will not create a disincentive to investment and savings as they are used to correct for market failure (Mirrlees *et al.*, 2011, p.476). For this reason variable tax rates are used to increase the price of a harmful activity as a means to discourage the harmful activity. Carbon emission and congestion, and alcohol and tobacco consumption are good examples due to the harm they cause to those who do not consume alcohol and tobacco, as well as to the population who do not benefit from consuming the carbon emissions and end up suffering from related diseases. Sin taxes (for example excise tax on cigarettes) therefore enhance economic efficiency. The same is true in the case of positive externalities, for example with the provision of education which confers more social benefits to a community accruing to even those who do not pay for it (Black, Calitz & Steenekamp, 2005, p.41). In this case a subsidy or negative Pigouvian tax will improve economic efficiency by internalising the marginal external benefit of education (Black, Calitz & Steenekamp, 2005, p.40).

Furthermore, Mirrlees *et al.* (2011, p.474) suggested that all incomes should be taxed with a single rate structure, because different rate structures complicate tax systems and distort economic activities and unjustly favour those taxed at lower rates. It also makes tax avoidance easier, which affects the revenue-raising potential of the tax.

### **2.2.2 Administrative Efficiency**

Administrative efficiency involves minimising both administrative and compliance costs which are the costs to government of administering the taxes and the costs incurred by taxpayers to comply with their tax obligations (Black *et al.*, 2011, p.193). The writers also refer to empirical evidence of cases where compliance costs were significantly higher than administrative costs. Stiglitz (2000, p.458) referred to ‘administrative simplicity’ as the norm and explains that this means that administration and compliance costs should be low.<sup>2</sup>

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<sup>2</sup> Stiglitz (2000, p.464) defines administrative costs as the costs of running the revenue service.

Administrative efficiency requires that tax avoidance and evasion be reduced to a minimum (Black, Calitz & Steenekamp, 2005, p.146). Tax evasion, or just mere non-payment, can be attributed to a culture of non-payment in a society as well as to a lack of ability to pay. It is also more relevant in the informal sector, whereas tax avoidance on the other hand occurs when taxpayers take advantage of loopholes in the tax system to reduce their tax liability (Black, Calitz & Steenekamp, 2005, p.146). This will probably be higher in the formal sectors of the economy where tax payers can make use of tax experts to exploit loopholes (Fjeldstad, 2003, p.172). The extent of evasion can be measured by the tax gap<sup>3</sup> (Manasan, 2003, p.1). Another indicator of tax evasion and avoidance is the potential tax base difference between the number of persons who have chosen to register for tax purposes and the number of persons employed (Marino & Zizza, 1996, p.3).

According to (Black *et al.*, 2011, p.196) simplification is a golden rule in designing administratively efficient tax systems and they claim that "... Simple tax laws are easy to understand and comply with". Moreover, when a government does not take an active step in simplifying the administrative procedures and restructuring the tax system, it is not fair to expect more from the staff in terms of administrative capacity and integrity. As a result, increased autonomy may lead to greater corruption and mismanagement of taxes (Fjeldstad & Rakner, 2003, p.9).

Other factors that lead to administrative problems are found outside the scope of tax administration itself (Fjeldstad, 2005, p.8). Problems in tax administration can be caused by a decrease in real wages for administrative staff, as well as by an increase in fiscal corruption. To resolve this, it would be important to develop strict internal monitoring and penalties for non-compliance to rules and regulations. Nevertheless, hiring and firing may not help because corrupt officials work in networks, and firing them on one side may result in them being hired in the private sector due to the knowledge they have of the tax system and how to manipulate it (Fjeldstad, 2005, p.19).

Furthermore, because these officials work in networks, keeping inside contacts will strengthen their networks. Rotation work could be introduced as a solution but the problem is that staying in the same post for short periods of time may lead to uncertainty on the part of the employees. Consequently they might use their time in the post to enrich themselves while

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<sup>3</sup> The tax gap is the difference between the tax that should be paid and what is actually collected (Manasan, 2003, p.1).

in the post. Corrupt superiors may reassign officials to remote stations as a punishment for honesty. The problem of lack of skilled personnel aggravates this problem and makes the possibility of rotational work merely impossible in developing countries (Black, Calitz & Steenekamp, 2005, p.146-147).<sup>4</sup>

Literature suggests that the following points be present to ensure that tax administration is efficient. First, tax legislation should be simplified because then it is easy to understand and to comply with (Stiglitz, 2000, p.465). Second, economic theory states that the higher the sanctions the higher the compliance (Black, Calitz & Steenekamp, 2005, p.146; Doran, 2009, p.112). In other words, if the penalty for non-compliance is harsh then tax payers tend to pay their taxes more keenly than when the penalties are not rigid. Sometimes however, the way the law is enforced and the rigidity of sanctions reduce the citizens' trust in the authorities and fuel resistance (Fjeldstad & Rakner, 2003, p.10). Third, taxes should be withheld at source as is the case in the Pay-As-You-Earn system. In this way the authorities lay their hands on the salary before the taxpayers, preventing lags in the operation and ensuring a regular inflow of revenue for government. (Heady, 2002, p.7) Finally, incentives for tax delinquency should be minimized (Black, Calitz & Steenekamp, 2005, p.146). In other words, MTRs that are too high should be minimized and the poor should not be taxed differently, to avoid them from creating ways to escape the tax system.

### **2.2.3 Equity**

An equitable tax system is one which promotes an equitable and fair distribution of income (Black, Calitz & Steenekamp, 2005, p.122). The benefit principle and the ability-to-pay principle are the two principles on which equity is based. The benefit principle states that tax burden should be apportioned to taxpayers according to the benefits they receive (Black, Calitz & Steenekamp, 2005, p.122). In other words, the more an individual makes use of a public good like a bridge, the more the individual has to pay for this benefit. The ability-to-pay principle states that people with equal ability to pay should pay the same amount and those with more capacity should pay more. This principle incorporates both vertical and horizontal equity (Black, Calitz & Steenekamp, 2005, p.124).

Horizontal equity implies that individuals with the same ability to pay taxes should be taxed equally, regardless of their specific source of income (Profeta, 2003, p.11), and it is based on

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<sup>4</sup> See Section 2.3.1 for problems with tax administration in developing countries.

the definition of comprehensive income base. It is however difficult to measure and implement. Comprehensive income is anything that makes consumption possible, and includes donations, gifts, benefits and etc (Black, Calitz & Steenekamp, 2005, p.158). Vertical equity states that tax burdens should be distributed fairly across people with different abilities to pay (Rosen & Gayer, 2007, p.358). This would imply that higher tax rates should apply to higher levels of income, i.e. tax rates should be progressive.

However, progressive taxation may affect the economic behaviour of taxpayers. Tax systems should be designed in a way that reduces to the fullest the efficiency loss associated with achieving progressivity. Mirrlees *et al.* (2011, p.3) claimed that income taxation should be simple and realistically reflect taxpayer's responsiveness at the income levels. In other words, the rate structure should reflect the reality of the income distribution and taxpayers' reaction to taxes and benefits at the various income levels, their decision to work and the choice of how many hours to work, as well as other responses like tax avoidance, evasion and migration. Other characteristics to be considered when determining the rate structure include incentives for labour supply, potential earnings power and needs. For the groups more sensitive to taxation the argument that they should be taxed more generously is conditioned on other characteristics and could constitute unfair discrimination, considering that it creates the undesired incentive to acquire the specific characteristics which is favoured by tax laws.

Therefore, careful attention should be paid to the kind of progressivity desired, which should be looked at in terms of people's lifetime resources and not just their annual income. That can be achieved by considering the distribution of expenditure and not just of income, because people's borrowing and savings reflect their changing incomes and necessities over their lifetime. Thus the extent of progressivity will vary depending on whether it was measured using expenditure or income (Mirrlees *et al.*, 2011, p.473).

This brings us to the point of simplification of income taxes by reducing exemptions and decreasing the rate structure, which will also promote horizontal equality between persons (Heady, 2002, p.7). Vertical equity becomes relevant when the tax system is matured or developed. At this point public spending and revenues increase which will require a more complicated tax regime and higher administration costs. At *this* point the complicated structure will become too costly as it will raise administration costs and will in turn force a reduction in complexity (Profeta, 2003, p.16).

Governments will be forced to simplify the tax structure by starting to group individuals by creating, assigning and choosing the correct rate brackets, in a way that is politically optimal for each group. This implies a trade-off in the choice of the number of brackets to use. An increase in the number of brackets means that there will be a reduction in expected support and a decrease means that administration costs will decrease and revenue will increase. Hence it will be possible to increase public spending which in turn can lead to increased support from voters. Therefore, a well-developed system is at a point where the costs from the system are so high that the need to simplify the tax system is predominant and justified, at which point there will be a need for special provisions to achieve political optimality (Profeta, 2003, p.13). This is very important because it leads to politically responsible behaviour from government. A simplified tax system tends to be more transparent and this way the burden to each tax payer is clear (Stiglitz, 2000, p.467).

There is an important trade-off between work incentives and income distribution, hence it has been pointed out that taxes on income and benefits are the right apparatus because their rates can be adjusted to the desired progressivity. Ahmad and Stern (1989, p.1065) are of the opinion that non-cash fringe-benefits should be included in personal income taxation, because that would allow for some equality, as the ones who possess these benefits (e.g. housing and cars) are the richer and not the poor.

#### **2.2.4 Flexibility**

The concept of flexibility implies that it should be possible to adjust tax changes to economic circumstances to facilitate macroeconomic stability and economic development (Black, Calitz & Steenekamp, 2005, p.122). Economic performance in general is characterized by recessions, booms, as well as by structural changes and taxes should have enough flexibility to accommodate these changes (Black, Calitz & Steenekamp, 2005, p.147).

Flexibility can be addressed both from the supply or the demand side (Black, Calitz & Steenekamp, 2005, p.147). Taxes can influence economic activity from the supply side through, for example, the impact on the supply of work effort or on the incentive to save. For example, should the wage elasticity of supply of female workers be higher than that of males, it would imply that females should be taxed at lower MTRs to encourage them to participate in the labour market.

On the demand side, stabilization policy can be used to smooth out business cycles.

Black *et al.* (2011, p.289) state that “Keynesian economists and policy makers also believed that income taxes and unemployment benefits strengthen the demand-stabilizing impact of active fiscal policy”. Automatic stabilizers, referring to income tax and unemployment benefits, are fiscal policies that are inherent in the law, because they do not require new legislation since the economic conditions generate changes in the government revenue and expenditure without any deliberate government action (Swanepoel & Schoeman, 2002, p.568). A good example of such policy is progressive income taxation that acts as a built-in or automatic stabilizer. With automatic stabilizers, when there is a recession the average income tax rate will automatically begin to decrease and the opposite is true in the case of an economic boom.

An important factor that poses difficulties in flexibility is that governments may face political difficulty in adjusting the tax rates (Stiglitz, 2000, p.466). Depending on the complexity of the tax system and rates much political debate is generated on deciding which rates to adjust and how tax payers are to bear the burden of an increase in the tax rates.

The speed of adjustment is also a very important aspect of flexibility when it comes to stabilizing the economy (Stiglitz, 2000, p.466). When the lags in the economy are too long, it can happen that by the time the increase in the tax rate is taking place, the economy might just be in need of a tax reduction or vice versa. Swanepoel and Schoeman (2002, p.569) explained that economic adjustments and their effects are exposed to variable and irregular time lags, making it hard to calculate the actual size of the yearly budget deficit.

What developing countries need is to facilitate trade and enhance the supply response to remove barriers to trade (Morrissey, 2005, p.1135). Increasing exports is not enough as exports will increase the inflows of foreign exchange which could appreciate the exchange rate and be bad for international trade. In addition, increases in exports should be accompanied by increases in demand for imports (Morrissey, 2005, p.1137); this way the economy becomes more flexible or responsive to shocks.

#### **2.2.5 Political Responsibility**

According to Stiglitz (2000, p.467), the norm of political responsibility entails that the tax system must be transparent and come about as a result of legislation. In other words, the burden of payment should be clear to the tax payer and the one who benefits should also be clearly identified. Sometimes governments purposefully tend to misrepresent the true costs of



the services provided by the state. It should be clear if a tax is to be fully borne by the employee or the employers. Governments intentionally convince individuals to believe that the costs of government services are less than expected, so as not to shake public confidence and lower public morale. Stiglitz (2000, p.467) adds that corporation taxes are the least politically responsible because who really pays the tax is not apparent as taxes are paid by the people, not institutions.

Second, Stiglitz (2000, p.468) adds that a politically responsible tax should be one where changes to taxes come about as result of law changes and the tax changes should be evaluated afterwards by the citizens, to decide whether the government is spending too much or too little. Bird (2007, p.58) suggested that governments need to play “the right game”, which conforms to Stiglitz’s notion of political responsibility. Before a country can implement major changes in its tax system, it needs to apply major changes in its economic and/or political reality. During “stable” periods in the economy a good tax reform could act like a good seat belt law, in that *ceteris paribus*, the tax ratio will just continue to increase (lives will be saved). However in case of administrative downfalls, or any relevant shocks, the tax ratios will not be very responsive, because they are not shaken as they have a “safety belt on”. This great analogy by Bird (2007, p.58) shows that countries will achieve equilibrium according to the nature and size of their fiscal system which reflects the balance between their political strength and institutions, until they are shocked into a new equilibrium. This could be due to supply factors which change over time as a means to counteract all the attempts to raising the tax ratios, or because the perception of what is an optimal tax level may change over time, which is most probable.

#### **2.2.6 Institutionalisation of tax reforms**

Bird (2007, p.56) furthermore suggests that tax reforms should be institutionalised. Many reforms are focused on what to consider instead of how to proceed. Paying attention to the institutional arrangements in place before applying reforms, will improve the quality of the reforms, as well as increase the probability of their successful adoption and implementation. Bird (2007) gives four reasons for institutionalisation. First, better planning leads to better packaging, which weakens political opposition and attracts more political support. Second, in this way changes in the proposals can be made faster, while maintaining the core objective of the reform. Third, arguments which are politically appealing but incorrect can be rebutted if

supported by accurate studies. Last, it allows politicians to have better timing and presentation control of the process.

## **2.3 EMPIRICAL EVIDENCE ON TAX POLICY IN DEVELOPING COUNTRIES**

This section focuses on empirical evidence of tax reforms in developing countries. First, the aim is to give a descriptive overview of special features of tax systems in developing countries. It is important to point out that these recent changes being implemented in developing countries are the same ones being implemented in developed countries. This is besides there being significant differences in their cultural, political and economic background. This section also discusses factors that determine tax changes in developing countries in general.

### **2.3.1 Special Features and Constraints of Tax Systems and Administration**

Developed countries differ from developing countries in multiple tax-relevant ways, for example, the size of the formal sector, administrative capacity, the standard type of businesses and levels of income per capita income, amongst others (Heady, 2002, p.1).

#### *Complex administration and weak capacity*

Tax offices in developing countries often lack administrative capacity and administrative procedures such as reporting tax revenues, which are poorly monitored partly because the tax officials lack the necessary training (Black, Calitz & Steenekamp, 2005, p.146). This is the case in many sub-Saharan African countries. Despite recent tax reforms, it is still evident that tax systems in developing countries remain complex, lack transparency and have too many rate structures which make it hard for taxpayers to comprehend (Fjeldstad & Rakner, 2003, p.29). Tax laws are written in a complex way and there are hardly any manuals of instruction for taxpayers. In addition, the sanctions available for non-compliance to the tax laws are often weak (Ahmad & Stern, 1989, p.1030). As a result, the tax system becomes costly to administer and the complexity creates loopholes for corruption and mismanagement.

According to the World Bank chief, Jim Yong Kim, corruption is the biggest problem faced by developing countries (Economic Times, 2013). Government regulation is set in a way that does not allow prices to be flexible (Jerome & Ogunkola, 2000, p.11). As a result, the citizens tend to create a secondary economy, which is more responsive to changes in the economy.



This economy is also known as the black or informal market and can be as big as the formal economy, or even bigger (Killick, 1993, p.11). This illustrates a paradox: these economies are inflexible but the citizens are rapidly able to adapt to changes in a very resourceful and entrepreneurial way by resorting to the informal sector. The problem is that these people who are rapidly responsive are in the informal market, and have economic restraints in a way that the fruits of all their efforts do not result in a flexible national economy (Killick; 1993, p.11).

The question of proper tax administration in developing countries becomes even more delicate when dealing with small businesses, for two reasons. First, because their potential contribution, together with medium-sized businesses, can represent up to a quarter of total revenue (Shome, 2004, p.4). Considering that only a small part of this revenue is actually collected in developing countries, it is important that potential revenue is strictly targeted to maximize revenue collection.

#### *Low levels of per capita income*

According to Fjeldstad and Rakner (2003, p.1) developing countries face the following dilemmas relevant to tax policy: first, there is an urgent need to generate more revenue to sustain the delivery of public services. Second, those with economic ability to pay tax are few and often evade and avoid taxes. Third, those who do not pay and who are unable to pay tax are many and often resist the tax system as whole. Tanzi and Howell (2000, p.308) confirmed this and mentioned that personal income has yielded little revenue for developing countries because the number of citizens subject to this tax is small and the group that is subject to the higher MTRs is even smaller.

Considering the income disparities faced by developing countries, this creates tremendous pressure on the individuals who are on the tax base. This causes redistribution to be rather ineffective. With regards to exemptions in personal incomes for the sake of redistribution and administration, Ahmad and Stern (1989, p.1065) argue that low exemption levels might bring more taxpayers into the tax net than is possibly manageable by the authorities. On the other side, high levels of exemption will cause government to lose revenue and will probably be perceived as unfair by the population. According to Ahmad and Stern (1989, p.1065) this is the trend many developing countries erroneously like to follow and should only be permissible if administrative resources are scarce. As long as exemptions increase slower than Gross National Products per capita, a greater part of the population will be brought into the income tax net, and this will work in favour of a growing role of personal income tax.

### *Special treatment of small businesses*

Small- and medium-sized businesses play an important role in developing countries to stimulate economic growth and create jobs. According to Black *et al.* (2011, p.223) “It is also recognised, however, that the tax system severely affects this type of business in so far as tax compliance is concerned”. In many developing countries policy makers try to provide some assistance for small business through the tax system, such as allowing certain tax incentives, or special depreciation allowances, or to tax these enterprises on a cash flow basis. One of the economic constraints for developing countries in Africa is that tax bases are too small, implying that there are limited ways to increase revenue through taxation. For this reason priority is given to the more favourable tax treatment of small- and medium enterprises.

### *Informal sector activity*

It became clear that many normal economic activities which should be measured and taxed were taking place in informal economies (Tanzi, 1999, p.338). In countries where tax administration is a problem, monitoring these can be close to impossible. The activities of economic agents in this sector of the economy escape the attention of public officials, i.e. regulatory or tax authorities, and all informal activities are thus not captured in the official statistics. The greater the potential tax liability, the greater the distortion between gross and net earnings, resulting in a greater incentive for individuals to participate in the informal economy.

On the other hand, in developing countries, where unemployment is often rife, informal activity is often a survivalist strategy. Due to globalisation and trade liberalisation, domestic firms in many developing countries are unable to compete with the multinational corporations which have entered their markets. Loopholes in tax administration have also allowed for the growth or at least not enforced the eradication of the informal sector (Tanzi & Zee, 2000, p.300) and consequently the tax gap. Moreover, although high tax rates are a very important reason for the existence of the informal sector, it is not the main reason (Ahmad & Stern, 1989, p.1035). Overlaps exist between criminal activities and tax evasion. This is to say that a decrease in the tax rates is unlikely to eradicate the informal sector because it involves a heavy cycle of drug addictions, substance abuse and illicit trades in the market by very powerful groups like the mafia. In addition, developing countries tend to have a considerable amount of other informal sector activities that are difficult to monitor and tax, such as small scale farming and household production in agriculture (Ahmad & Stern, 1989, p.1035).

### **2.3.2 Factors Determining Tax Changes in Developing Countries**

Apart from these special features, there are three specific factors that significantly influence tax policy changes in developing countries: democratisation, declining aid flows and globalisation (Fjeldstad & Rakner, 2003, p.1). The first two factors are of particular relevance in the South African context. In the face of democratization, governments hoping to seek power based on popular consent are restricted in using their political power to impose taxation collection measures and regimes. Second, aid flows to developing countries are decreasing, leaving developing countries more dependent on their own tax revenues. Last, due to globalisation there is increasing integration of the world's capital and goods markets (Fjeldstad & Rakner, 2003, p.1). Consequently countries have to conform to investment and international trade agreements.

#### **2.3.2.1 Democratization**

The literature indicates that a democratic transition is closely linked to an economic transition (Profeta, Pugliesi & Scabrosetti, 2010, p.2). The implementation of tax design and reforms are at the core of economic policy. This is an important factor in determining the direction of public policies and reforms, especially of redistribution through taxation and public spending. In democratic countries, tax reforms need voters' support for their implementation. Hence, policymakers will always try to structure tax policies that please as many voters as possible (Haggard & Kaufman, 1995, p.166). These policies can push and pull the majority of interest groups which greatly influences the decision of which party is to stay in power according to the fiscal advantages the party offers, in relation to other parties (Profeta, Pugliesi & Scabrosetti, 2010, p.1). Economic transitions interrelate with political transitions because of globalisation, as well the organisation of democracy. This is because an increase in economic welfare alone is not enough to support and introduce a democracy. Stable democracies in turn gear liberalisation and economic reforms which have a positive effect on the overall performance of the economies (Profeta, Pugliesi & Scabrosetti, 2010, p.6).

The main goal of taxation in a democratic economy is to raise sufficient revenue from its citizens, in often poor and increasingly open economies, to provide public goods and services. Tax decisions impact on the provision of public services as well as on the democracy itself. Therefore, tax systems should be designed in a way that is fair, to maximize the productive potential of the economy as well as the economic welfare (Mirrlees *et al.*, 2011, p.24). Following from this point, it is advisable that tax reforms should be risk averse (Diamond & Zodrow, 2008, p.175) so that revenue yields are not negatively affected and

undesirable inequalities do not result, because important goals of tax reforms will always be to enhance revenue, reduce budget deficits and reduce inequality.

Hence, it is imperative that governments be patient and committed with tax reforms. That always means that they will have to use their capital, both political and financial, to bring about the desired changes. In certain instances the costs of the tax reform are concentrated among a certain group but the benefits are widespread which can create serious opposition for government. This means that there are high risks and costs for governments engaging in tax reforms. While the costs are immediate, the benefits are often only seen in the medium- to long-run (Fjeldstad & Rakner, 2003, p.28). Moreover, improved tax structures from tax reforms will not prevail unless they are properly administered, as found by Heller and Shell (1974, p.345).

During a democratic transition, the influence of interest groups may interact with voters' preference in determining the outcome of public policies in a more persuasive way than in mature economies. Therefore, transitional arrangements need to be thoroughly analyzed for the medium- and long-term so that businesses are encouraged and investment risks decreased. This should enable the government to reach the many objectives of the tax reforms required for a credible tax regime, and higher levels of business confidence. There should also be an adjustment period before reforms are implemented (Khalilzadeh-Shirazi & Shah, 1991, p.46) to be politically feasible, which conforms to the notion of Stiglitz (see Section 2.2.5).

Since tax reforms take time, some governments may opt for more short-term reforms due to their practicality as well as for political reasons. Therefore, it is important to make sure that coordinated tax reforms are more consistent with the overall tax objectives than individual ones. They enhance overall economic performance. Individual or short-term reforms may increase fiscal deficits and aggravate macroeconomic imbalances. Tax reforms should be linked to reforms in the public sector as well as restructuring of the economy in general. In addition proceeds from tax reforms should not be used to finance an inefficient set of public expenditures (Khalilzadeh-Shirazi & Shah, 1991, p.45).

Taxes are important tools of redistribution under a democratic regime. Democracy encourages redistribution from the rich to the poor through either an enlarged welfare state or a reformed tax system which relies more on direct taxation to bring about redistribution. Tax reforms also promote equality because they allow the lower income groups to partake in the political process, thus it should ideally lead to the design of policies that favour these groups,

i.e. the physically disabled, the elderly, children, the sick and the unemployed. For low levels of democracy<sup>5</sup>, public spending is high to satisfy the needs and demands for rents of the elite, whereas for high levels of democracy, public spending is high due to the increase in the demand for public goods. This shows that it is more efficient for government to function under democracy. In general it seems, tax systems of democracies are designed in a way that encourages voluntary tax compliance (Profeta, Pugliesi & Scabrosetti, 2010, p.7).

When considering tax reforms it is important to make a thorough cost-benefit analysis of the revenue collection. This includes the compliance costs to tax payers as well as the direct costs of tax administration. Corruption and tax evasion need to be decreased as well the elimination of ineffective tax preferences. Although it may be a timely route, if a country is aimed towards simplification it will make the transition a lot smoother. However, that does not mean that simplification will not cause distortions in the system (Bird & Wallace, 2003, p.7).

### **2.3.2.2 Declining aid flows**

Foreign aid to developing countries has been decreasing since the early 1990s. Aid to the developing countries, relative to donor-country GDP, had fallen from 0.35% in 1970s to 0.25% in 1996. (O'Connell & Soludo, 1998, p.2). This has rendered it much more important to increase the revenue-raising capacity of tax systems in developing countries.

However, especially in Africa, aid and aid dependency has put a stop to the development of tax-accountability relations between the state and its citizens (Gloppen & Rakner, 2002, p.5). In addition, lack of administrative capacity and transparency also add to this aid dependency. The presence of foreign forces and forms of capital leaves the state unaccountable towards its citizens. In other words, government neither requires public support, nor the assent of their own laws, because the revenue is not being raised from the local economy. All they need is to keep the donors satisfied and willing to continue to provide assistance (Gloppen & Rakner, 2002, p.5). This has, implicitly, prevented these countries from exploring their revenue raising potentials. On the one hand it has been good to see African countries trying to sustain themselves. On the other hand, the years of aid have left many African countries unable to sustain themselves, both politically and economically. The effect is that when they are unable to find financial autonomy conflicts are generated.

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<sup>5</sup> Low levels of democracies are characterised by social movements, interest group activities and political party mobilization, low levels of political violence and less or ineffective state monitoring and has a high involvement in semi-legal and illegal actors in public politics (Tilly, 2007, p.20)

### **2.3.2.3 Globalisation**

Globalisation is the binding of different national economies into a single world economy due to increasing trade, investment and financial flows, rapid transfers of technology and greater labour mobility (Ouattara, 1997, p.107). In other words, business and individuals have greater freedom to take advantage of economic opportunities abroad, thus increasing the sensitivity of investment and local taxation decisions.<sup>6</sup> This creates a pressure in countries to reduce the tax rates to avoid pushing away the tax payers, which in turn increases international tax competition.

#### *Loss of Fiscal Autonomy*

Due to globalisation, countries have been forced to revise their tax structures, their administration and compliance. They have had to be more sensitive to changes in tax policy of their competitors and trading partners. As a result, countries are losing their fiscal autonomy regarding tax policies. Asher and Rajan, (1999, p.5) referring to Musgrave (1959) noted that globalisation reinforces two important rules of conventional wisdom. First, income taxes should not be higher in countries that import capital, than in countries that export capital. Second, that corporate income tax must not be lower than the highest rate of individual income tax. One of the possible theoretical solutions is harmonizing the tax base for individuals and businesses.

#### *Tax Competition*

Globalisation creates international pressure to compete for and attract foreign investment, as well as for the purchasing power of neighbouring consumers due to the increased mobility of labour and capital, but often at the cost of pursuing more essential tax reforms (Tanzi & Howell, 2000, p.319). Actually, many countries have pursued tax reforms with the intent of attracting foreign investment as a means of increasing the tax base and consequently tax revenue. This competitive international environment has made countries adopt defensive policies to prevent resident tax payers from enjoying lower tax rates abroad. Foreign Direct Investment (FDI) is important for overall economic growth, by increasing revenue potential with the creation of jobs and increasing both corporate and personal income tax revenue,

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<sup>6</sup> For example recent fuel, food and commodity shocks as well as the global financial crisis in 2008, seriously affected economic growth in African developing countries, particularly because it happened at a time when many African economies were starting to see results from economic and political reforms. The financial crisis caused falling commodity prices and export revenues, and declining capital flows, seriously affecting tax revenue (Almquist, 2009, p.22).



among others. For this reason, countries compete with each other by offering the more attractive tax rates, various types of tax incentives as well as other fiscal and non-fiscal allowances (Asher & Rajan, 1999, p.10).

In the global economy with capital mobility, tax structures are moving away from a dependence on corporation income tax, due to capital being able to move more freely between countries. In the face of globalisation, the factors of production migrate to the countries where the taxes are lower. Therefore, the countries start competing with lower tax rates and decreased capital taxes. The literature on tax competition shows that globalisation is negatively related to capital taxation (Profeta, 2003, p.17). Developing countries are now seeking to draw foreign direct investment and for these reasons the income tax rates for corporations and persons have been significantly decreased over the world, consequently, leading to decreases in revenues, in government's capacity to redistribute and a decline in expenditures (Dreher, 2003, p.5).

#### *Tax harmonisation*

A response to tax competition includes tax harmonisation between countries, hence restricting countries from offering tax rates that are too generous to inflows of foreign investments. These tax responses are far from realistic because they do not promote economic growth or to reform inefficient tax systems. They should instead adopt pro-growth tax policies by learning from tax policies in other countries (Edwards, 2010, p.37). This has led to the harmonisation of the tax rates and the tax bases. In Southern Africa Botswana, Lesotho, South Africa and Namibia (BLSN) have been integrated for years both historically and by agreement. There is a Southern African Customs Union (SACU) agreement that allows for goods to be exchanged between the BLSN countries with a common external and excise tariff and the revenue is shared among the member countries (Black, Calitz & Steenekamp, 2005, p.151).

Nowadays, finance and services are among the fastest growing areas of foreign investment, as well as intangibles like trademarks, knowledge and patents, whose profits can easily be moved to low-tax countries. For these reasons among many others, many industries have become rather sensitive to tax rates today and so is foreign direct investment. As a consequence of globalisation tax treaties have been created between countries to harmonise taxes, prevent fiscal evasion and avoid double taxation (OECD, 2001, p.5). This has strengthened the economic relations between countries by promoting cooperation between tax

authorities. In addition, tax treaties have improved the tax consequences of foreign investment.

#### *Lower trade and excise taxes*

In general developing countries are highly reliant on trade taxes for revenue purposes. However, trade taxes create economic distortions and thus increase economic inefficiency and excess burden. The distortionary impact is evident from the positive growth experience of the countries which have become open to international trade (Heady, 2002, p.4).

However, there has been a decrease in trade taxes all over the world. The argument for the reduction is that imposing trade taxes on narrow bases of developing countries can cause revenue shortfalls if the base does not grow as fast as the economy. This has been due to developing countries' desire to be a part of the World Trade Organization (WTO) (Tanzi & Zee, 2000, p.307). The WTO is of the opinion that because trade taxes are inefficient, they should be reduced and eventually eliminated to make the tax systems more efficient (Emran & Stiglitz, 2005, p.619). Most developing countries reacted to this reduction in revenue from trade taxes by increasing consumption taxes such as VAT which is more efficient. According to Black *et al.* (2011, p.270) developing countries still rely on trade taxes for 21.1% of their tax revenue.<sup>7</sup>

Furthermore, the increase in cross-border shopping, phone or mail order and internet shopping, have led to the imposition of ceilings on excise and sales taxes (Asher & Rajan, 1999, p.21).

#### *Introduction of Value Added Tax*

Currently developing countries rely particularly on VAT for much of their tax revenue (Black *et al.*, 2011, p.270). The imposition of VAT is an effective way to compensate for the revenue loss from reduction in trade taxes and as a substitute for commodity taxes. First, because it broadens the tax base, reduces distortions in relative prices and allows the economy to grow in line with GDP, and enhances international competitiveness as it can be completely removed from exports (Heady, 2002, p.5). Second, because it encourages

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<sup>7</sup> This is in contrast to developed countries, where trade taxes only make up 0.8 % of tax revenue (Black *et al.*, 2011, p.270).



compliance as it is self-enforceable. Last, it ends the cascading effect involved in turnover taxes and manufacture's sales tax systems.

Disadvantages include the fact that it is a difficult tax to administer and it can be regressive if applied at a single rate (Heady, 2002, p.6). According to Heady (2002, p.5) indirect taxes in developing countries have a tendency to be regressive with regards to income. But if the objects of indirect taxation are carefully selected then it can lead to a more progressive, or at least, proportional distribution, with respect to income (Ahmad & Stern, 1989, p.1021). However, expenditure on business inputs should not be subject to taxation; this is possible with VAT because the traders are allowed to claim back the VAT charged to them on their inputs (Mirrlees *et al.*, 2011, p.5). This way zero rates and tax exemptions are avoided, as they disable the deduction of input costs, even though these are the current tendencies with VAT (Bahl & Bird, 2008, p.14).

## **2.4 SUMMARY**

This chapter first discussed the conventional norms to which tax systems should comply. It explained the meaning of administrative efficiency, which is important for collecting maximum revenue, and of economic efficiency, which requires that taxes should distort the decisions of economic participants as little as possible. It also explained the importance of politically responsible tax reforms in order for the reforms to be accepted by the taxpayers.

The second part of this chapter focused on tax policy in developing countries and highlights special features of developing countries that are important for tax policy. These are the weak administrative capacities, low per capita incomes, special treatment of small business and the existence of informal sectors. It also discussed democratisation, declining aid flows and globalisation as three factors that also influenced tax changes in developing countries. Globalisation is particularly relevant in the South African context. It explained that globalisation has led to tax competition between countries which encouraged tax harmonisation and the signing of tax treaties as well as a general decrease in tax rates on income all over the world. Because of WTO rules trade taxes have also been reduced and many countries introduced VAT to compensate for the revenue loss.

## **CHAPTER THREE**

### **AN ECONOMIC APPRAISAL OF THE CHANGES TO THE SOUTH AFRICAN TAX STRUCTURE SINCE THE 1990s**

#### **3.1 INTRODUCTION**

As discussed in Section 1.1 the changes to the South African tax system since the 1990s occurred during two phases: the first phase covers the period between the Margo (1987) and the Katz Commissions (1994–1999) and the second phase the period after Katz to 2010. First this chapter gives a descriptive overview of some of the specific changes to the South African tax system, explaining the rationale in terms of the theoretical framework, as well as some evidence from developing countries. The second part of the chapter tries to answer the question of whether the intended objectives with the specific changes were achieved.

#### **3.2 CHANGES TO THE TAX SYSTEM: 1990 - 2010**

##### **3.2.1 Phase One: 1987 - 1994**

The Margo Commission was appointed in 1987 (Black, Calitz & Steenekamp, 2005, p.154). As mentioned earlier in Section 1.1 this was a difficult period in the economic history of South Africa, which caused major fiscal challenges. The intention with the appointment with this commission was to restructure the existing tax structure by focusing on broadening the tax base. The reforms aimed at creating jobs, reducing the brain-drain, improving tax compliance and morality, encouraging capital formation, encouraging immigration, and promoting entrepreneurship (Black, Calitz & Steenekamp, 2005, p.154).

The following sections give an overview of the most important changes to the South African tax system, as well as the economic rationale behind, during this period.

##### **3.2.1.1 Income taxation**

###### *a) Personal Income Tax*

The individual became the standard unit of taxation which allowed for the equal treatment of both genders and enhances tax neutrality (Black, Calitz & Steenekamp, 2005, p.155). To women it was very important that the unit of taxation be changed from the couple to the individual. Previously, married women faced higher MTRs in comparison to married men and unmarried persons. This was discrimination against women which negatively affected the

neutrality of the tax and therefore distorted women's choice to work after marriage. This was based on the assumptions that married couples enjoyed economies of scale<sup>8</sup> (Budlender, Casale & Valodia. 2010, p. 211), married women's salary would be an extra to the household and consequently could be taxed at a higher rate and that married couples would share their incomes; hence, the married women's high MTRs would be offset by the husband's low income tax rate. This meant that the tax burden on married women was higher than on other taxpayers.

The Commission recommended that the income tax should have fewer and broader brackets and lower MTRs (Black, Calitz & Steenekamp, 2005, p.154). This was to make the income tax structure simpler and to facilitate its administration.

Top marginal rates were set at 45% in fiscal year 1987/88 from 50% in 1986/87 and decreased to 43% in 1991/92; the number of tax brackets were as many as 19 in fiscal 1988/89 and decreased to only 9 in fiscal year 1992/93.

Fringe benefits provided by employers, such as housing and housing assistance schemes, travel allowances and rental of movable and immovable property, became taxable in 1985 (Republic of South Africa, 1985, p. 3). They were often partially exempt from tax as a way of compensating for the high MTRs on personal income (Steenekamp, 2012b, p.13). Bringing fringe benefits into the tax net was thus aimed at greater economic efficiency as it eliminated unnecessary distortions that also created loopholes for tax evasion. The impact on income distribution would also have been positive, as lower categories of salary earners generally do not receive fringe benefits.

The Margo Commission also recommended that the tax system should not be made more progressive to enhance its impact on the redistribution of income. This was because of the changed distribution of benefits in government expenditure: government was to spend more on previously disadvantaged blacks and less on whites. It is generally accepted that the expenditure side of the budget is a more efficient tool for redistribution. Blacks were to receive greater levels of service and whites were going to spend more for education, health and other public services for this redistributive purpose. For this reason the change in this

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<sup>8</sup> Married couples would enjoy economies of scale in that because they live together, they would pay only one rent and their living costs would be shared, and so would be cheaper than for a person living alone.

distribution of benefits and costs had to be accompanied by a shift in the tax burden (McGrath, 1991, p.17).

*b) Company Income Tax*

A secondary tax on companies (STC) was introduced in 1993 (Koch, Schoeman & Van Tonder, 2005, p.194) as a tax on distributed profits. It was introduced to encourage firms to re-invest their profits and consequently promote economic growth. It was also a way to re-introduce taxation of dividends which had been exempted in 1990 (Black, Calitz & Steenekamp, 2005, p.155). The taxation of dividends had been abolished because it created distortions of the return on debt and equity funding and in the selection of the form of business organisation. Moreover, nothing prohibited companies from passing on profits from one company to another as dividends, and the undistributed profits tax could only be levied on undistributed dividend income (Lombard, 1996, p.36).

The reduction in company tax rates<sup>9</sup> are reflected on the table below:

**Table 3.1 Rate of Nominal Tax on Companies, 1990 - 1994**

Year of Assessment	Flat rate on taxable income %	Rate of STC
1989/90	50	-
1990/91	50	-
1991/92	48	-
1992/93	48	-
1993/94	40	15
1994/95	35	25

Source: Adapted from Adapted from SARB (2012, p.90)

Company tax rates were reduced from 50% in fiscal 1990/91 to 40% in fiscal 1993/94, the year of the establishment of the new democratic government in South Africa. In addition, the flat rate of company tax was reduced to 35% in 1994/95, to mitigate the introduction of the STC, because the introduction of STC increased the effective tax rate on companies (Koch, Schoeman & Van Tonder, 2005, p.194). This meant that the STC decreased the

<sup>9</sup> Company tax rates exclude the mining sector

competitiveness of South African companies, which in turn was not good for attracting foreign investment.

The reduction in nominal tax rates in 1994 was implemented to reduce the burden of the combined corporate tax rates as well as the distorting effects of the STC (Katz Commission, 1996, p.22). This was very important, given the demands of the new democracy and the urgency of attracting foreign direct investment in order to grow the economy. In addition, because of globalisation businesses had greater freedom to take advantages of investment opportunities abroad, leaving it sensitive to tax rates. South Africa was forced to reduce its nominal tax rates to avoid pushing away investments and skilled labour.

### *c) Capital gains tax (CGT)*

The possible introduction of a CGT had been investigated, but rejected, by the Margo Commission. The commission was against any form of wealth taxation as it could distort investment away from productive assets (McGrath, 1991, p.17). This explanation is interesting as the Commission referred to CGT as a tax on wealth, whereas it is generally treated as an income tax. A capital gain, just as a salary, forms part of the comprehensive income base, or the Haig Simons' definition of income (Black, Calitz & Steenekamp, 2005, p.158).

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### **3.2.1.2 Indirect taxes**

#### *a) Value Added Tax*

VAT was introduced in 1991 to replace the General Sales Tax (GST) (Black, Calitz & Steenekamp, 2005, p.205). It was initially levied at 10% and the rate was increased to 14% in April 1993 (Black, Calitz & Steenekamp, 2005, p.205).

VAT was introduced, first, to minimize tax evasion because it covers a broader tax base and eradicated the cascading tax effect inherent in the GST (Black, Calitz & Steenekamp, 2005, p.154). The cascading effect occurred because the tax was levied on the purchase of inputs and ultimately on the value of the sales which is the output (United States. Congressional Budget Office, 1992, p.26). It was levied on a significantly broad base, including on all registered vendors of goods, with the exemption of financial services, education, non-

governmental organisations and health services. It was also subject to zero-ratings and exemptions in some instances.<sup>10</sup>.

As VAT is levied at every stage of production and accumulates, it is comparable to a tax on all final household consumption (Tait, 1999, p.494). According to Keen (2006, p.4) because VAT is charged and/or refunded at all stages of production it does not distort the input prices of business, because there is no excess burden.

#### *b) Fuel levy*

Fuel levy in South Africa was first introduced as a GST at 4% ,or 1 cent per litre, in June 1978 (CEEPA, 2009, p.2), but was replaced in 1987 by a fuel levy at 30 cents a litre. Because the GST was a tax on sales and it could negatively affect financing of the oil industry; therefore it was replaced by the fuel tax because this is a tax on stock and could be brought into account from the point of sale oil company depots (SAPIA, 2002).

#### *c) Capital Transfer Tax*

Capital Transfer Tax was imposed to replace estate duty and donations tax (Black, Calitz & Steenekamp, 2005, p.154) and was levied at a flat rate of 15% on dutiable value of deceased estates exceeding R250 000. Despite the fact that the Commission was against taxing any form of wealth, and capital transfer tax is a tax on wealth, the Commission agreed it was not distortive as the rate was moderate and was unlikely to affect substantially the patterns of investments and savings. In addition, its revenue-raising potential was low (McGrath, 1991, p.17).

### **3.2.2 Phase Two: Katz Commission 1994- 1999**

The Katz Commission (1994–1999)<sup>11</sup> was the first tax reform investigation in the post-apartheid period under the new democratic government (Manuel, 2002, p.4). South Africa was accepted into the world economy again and the period of trade and financial sanctions came to an end, but the integration into the world economy brought its own challenges. As discussed in Section 2.3.1 many developing countries make changes to their tax structures

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<sup>10</sup> Certain commodities that are highly consumed by low-income households are zero-rated. Basic food items like pilchards, brown bread, dried beans, samp, vegetable oil, maize meal, lentils, mealie rice, dried mealies, milk powder, unprocessed vegetables and fruit, rice and eggs were exempted from VAT in 1991 (Cnossen 2003, p.6).

<sup>11</sup> Between 1994 and 1999, nine interim reports were issued (South Africa. National Treasury, 2000, p.3)

following the establishment of new democratic governments, because of declining aid flows and because of the demands of globalisation.

The main aims of the Katz Commission at the time were to improve tax collection and administration; improve the neutrality of the tax base; reduce government borrowing; close loopholes in the tax system; and re-evaluate equity aspects of many taxes (Koch, Schoeman & Van Tonder, 2005, p.194). The Katz Commission in general aimed to maximize equity, flexibility, efficiency and simplicity of the South African tax system (Katz Commission, 1996, p.2).

The following sub-sections present an overview of the main changes to the South African tax system during the second phase.

### **3.2.2.1 South African Revenue Services**

A very significant institutional change was the establishment of the South African Revenue Service (SARS) on 18<sup>th</sup> October 1995 as an autonomous agency responsible for revenue collection and administration (South Africa. National Treasury, 1996, p.8). SARS was a merger between the previous departments of Inland Revenue and Customs and Excise, created to increase the efficiency of the tax administration (SARB, 2013, p.5). Previously, both the Departments of Inland Revenue and Customs and Excise showed a continuous decline in their efficiency and the departments were, in addition faced with a loss of skilled personnel (Katz Commission, 1996, p.6). As a consequence, effective tax collection and administration of customs regulations declined significantly, lowering the morale of taxpayers. Establishing SARS was an important measure as efficient revenue collection was an important priority of the new democratic government, given the pressure to increase revenue in order to attend to the needs of the previously disenfranchised population, and to deliver on pre-election promises.

The main objectives of SARS were to collect all national taxes, levies and duties efficiently, and to attract and preserve skilled personnel by adopting organisational structures that enhanced efficiency, improved human resource management practices, incentive schemes and by making use of modern information technology (Liebenberg, 1996, p.8). As explained in Section 2.2.6, Bird (2007, p.56) suggests that tax reforms should be institutionalised. In South Africa, this was achieved with the establishment of SARS. At a practical level, SARS had to oversee the proper implementation of the reforms, following the recommendations of the Katz Commission.

### **3.2.2.2 Income taxes**

#### *a) Personal Income Tax*

Following international practice, there was a gradual decrease in MTRs on personal income in South Africa. This was in line with the gradual global decrease in MTRs on individuals' income. As discussed in Section 2.3.2.3 this was caused by tax competition between countries due to globalisation. Especially in the case of South Africa as a developing country, it was important to consider the impact of relatively high tax rates on 'brain drain'. Furthermore, the theoretical excess burden is also expected to decrease more than proportional to the decrease in the tax rates.

The decrease in MTRs is reflected in the table below:





**Table 3.2 Marginal Tax Rates in South Africa, 1990/91 - 2009/10**

Fiscal Year		1990/91	1991/92	1992/93	1993/94	1994/95	1995/96	1996/97	1997/98	1998/99	1999/00	2000/01	2001/02	2002/03	2003/04	2004/05	2005/06	2006/07	2007/08	2008/09	2009/10
<b>Lowest Marginal Tax Rate</b>		15%	14%	17%	17%	17%	17%	17%	19%	19%	19%	18%	18%	18%	18%	18%	18%	18%	18%	18%	18%
Values in Rands		1-4,000	1-5,000	1-5,000	1-5,000	1-5,000	1-5,000	1-15,000	1-30,000	1-31,000	1-33,000	1-35,000	1-38,000	1-40,000	1-70,000	1-74,000	1-80,000	1-100,000	1-112,500	1-122,000	1-132,000
<b>Highest Marginal Tax Rate</b>		44%	43%	43%	43%	43%	45%	45%	45%	45%	45%	42%	42%	40%	40%	40%	40%	40%	40%	40%	40%
Values in Rands		56,001 & above	56,001 & above	56,001 & above	56,001 & above	56,001 & above	80,001 & above	100,001 & above	100,001 & above	120,001 & above	120,001 & above	200,001 & above	215,001 & above	240,001 & above	255,001 & above	270,001 & above	300,001 & above	400,001 & above	450,001 & above	490,001 & above	525,001 & above
<b>Tax Threshold</b>	<b>Below 65 Yrs</b>	10,285	10,357	10,714	10,714	10,714	14,600	15,800	16,921	18,500	19,526	21,111	23,000	27,000	32,222	35,000	40,000	43,000	46,000	54,200	57,000
	<b>65 Yrs &amp; Above</b>	10,857	10,929	11,285	11,285	21,429	26,785	27,905	30,050	31,950	33,717	36,538	39,154	42,640	50,000	60,000	65,000	69,000	74,000	84,200	88,528

Source: Adapted from SARS, (2012, p.12-22) and Tomasek (2007)

In 1995/96 the highest marginal rate of 45% was set on the taxable income bracket of R80 000. It decreased to 42% in 2000/01 and to 40% in 2002/03. The top marginal rate remained at 40% until the end of the period under study, fiscal 2009/10. The lowest MTRs have been relatively stable throughout the years, remaining at 18% since 2000/01.

There was a reduction in the gradation of the income tax schedule (Katz Commission, 1996, p.9).

Tax brackets, standard deductions, credits and unadjusted tax rates and amounts were adjusted for inflation because of the fiscal drag. Tax brackets were reduced from 14 in 1990/91 to 8 in 1995/96 to 6 in 1997/98 (South Africa. National Treasury, 1998, p.12).

What happened was that after completion of the Katz Commission some individuals quickly progressed into the higher income tax brackets. As a consequence nominal salaries were inflated because the tax brackets were not indexed for inflation. This adjustment allowed for the decrease in the number of tax brackets.

The tax threshold was raised, removing the lower income payer from the tax register, to promote progressivity and simplify administration. Progressivity was promoted because the higher income earning groups paid more taxes and the really low income groups paid no tax. Administration would be simplified because taxes need not be deducted for a large group of low-income earners. The minimum tax threshold for persons under the age of 65 increased from R10 285 in 1990/91 to R57 000 in 2009/10. The threshold at which personal income became taxable increased, providing more protection to low-income earners and reducing the entry barriers into the formal labour market. It also reduced the burden on low-income earners.

PIT has undergone significant changes to enforce compliance on a broader tax base. In 1996, all tax schedules were comprised into two groups: a schedule for natural persons, including all individuals single or married, and a schedule for unnatural persons such as companies (Nyamongo & Schoeman, 2007, p.480).

From fiscal year 200/01 taxes were higher on unnatural persons than on individuals. Before that, taxes were lower for companies than on natural persons and consequently professionals, like lawyers and accountants among others, were able to escape the higher marginal rates of PIT by opening their own business and paying the lower CIT rates. They would draw off

their profits through expense deductions over time and escape chronically high PIT rates. These changes are shown in the table below:

**Table 3.3 Comparing top Marginal tax and Company tax rates, 1990 - 2010**

Year of Assessment	Company income tax %	Rate of STC	Top Marginal Tax Rate on Personal Income
1990/91	50	-	44
1991/92	48	-	43
1992/93	48	-	43
1993/94	40	15	43
1994/95	35	25	43
1995/96	35	25	45
1996/97	35	12.5	45
1997/98	35	12.5	45
1998/99	35	12.5	45
1999/00	30	12.5	45
2000/01	30	12.5	42
2001/02	30	12.5	42
2002/03	30	12.5	40
2003/04	30	12.5	40
2004/05	30	12.5	40
2005/06	29	12.5	40
2006/07	29	12.5	40
2007/08	29	10	40
2008/09	28	10	40
2009/10	28	10	40

Source: SARS (2012, p.12-22) and SARB (2013, p.90)

This system ended the discriminatory provisions in the income tax laws, as the top PIT rate became lower than the CIT rate as from fiscal 2002/03, thus allowing for greater economic efficiency. This was also the realization of one of the conventional rules of globalisation as explained in section 2.3.2.3. This provision meant that many professionals, like lawyers and accountants, who opted to open businesses to enjoy lower MTRs were no longer able to benefit in this way.

The lowering of the top MTRs allowed South Africa to retain and attract more highly skilled professionals, given that tax burdens are an option in worker location choices (Glenday,

2008, p.8). This was very important in the face of international mobility of labour. Significant differences in rates of PIT were inducing highly skilled individuals to emigrate to countries that offered lower MTRs, causing a brain drain in the country. According to Bailey (2003, p.235), South Africa had experienced a brain drain since before 1994, during the period of the Margo Commission. In South Africa the brain drain in the country was higher than actually measured during the period under study and slowed down in later years (Bhorat, Meyer & Mlatsheni, 2002, p.8).<sup>12</sup>

There was also removal of detrimental tax schemes that eroded the tax base, like the use of untaxed fringe benefits to design remuneration packages, very common in the 1990s, which resulted in significant loss of tax revenue. To correct for this deficiency, fringe benefits such as company cars, travelling allowances, housing and holiday accommodation became fully taxable (Katz Commission, 1996, p. 33-34). Anti-avoidance provisions (such as verification of claims) were implemented from 1997 to 1999 to verify for the exploitation of travel allowances, company car schemes and residential accommodation for employees (Nyamongo & Schoeman, 2007, p. 480). This way government gradually started to eliminate special incentives, in order to protect the tax base by minimising distortions and to decrease the opportunities for tax evasion. The taxing of fringe benefits also reduced tax avoidance not only by the imposition of the tax itself, but also by ensuring that employers' deductions were fully reflected the gross income of employees (South African National Treasury, 2010, p.15).

The taxing of capital gains in 2001 after the Katz period,<sup>13</sup> and the application of the residence-based principle of taxation, decreased tax avoidance because they prevented companies from putting extra money on stocks to benefit from no or lower tax rates.

#### *b) Company Income Tax*

Tax reforms in South Africa have tried to build a tax environment which is globally competitive and conducive to investment and economic growth because it is important that private investment is sustained by the tax regime (Manuel, 2002, p.4).

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<sup>12</sup> Many South Africans emigrated, particularly to the UK, and brain drain was highest in 1993 (Bhorat, Meyer & Mlatsheni, 2002, p.25).

<sup>13</sup> The Katz Commission recommended that capital gains tax should not be applied due to the lack of administrative capacity at the time (Katz Commission, 1996). Consequently it was only applied in 2001, by which time government felt that it had the necessary administrative capacity to implement the tax.

Nominal tax rates for companies were reduced to be in line with international practice, and because of increasing tax competition. As in the case of other developing countries, South Africa competes for foreign capital inflows. Decreasing the flat rate of CIT was done to improve the competitiveness of South African companies and promote foreign investments into the country. The lower rates would also have improved economic efficiency as lower taxes may decrease the level of evasion and avoidance.

Decreases in company tax rates over the years are reflected on the table below:

**Table 3.4 Rate of Nominal Tax on Companies, 1990 - 2010**

Year of Assessment	Rate of tax on taxable income %	Rate of STC
1995/96	35	25
1996/97	35	12.5
1997/98	35	12.5
1998/99	35	12.5
1999/00	30	12.5
2000/01	30	12.5
2001/02	30	12.5
2002/03	30	12.5
2003/04	30	12.5
2004/05	30	12.5
2005/06	29	12.5
2006/07	29	12.5
2007/08	29	10
2008/09	28	10
2009/10	28	10

Source: Adapted from SARB (2012, p.90)

In the fiscal year 1994/95 corporate rates were reduced to 35% from 40% in 1993/94 and then to 30% in 1999/00, to 25% in fiscal 2005/06 and eventually to 28% in fiscal 2008/09 (SARB, 2012, p.12). Since its introduction in fiscal 1993/94 at 15%, STC was initially increased to 25% in fiscal 1994/95 to compensate for the decrease in corporate tax rates in the same year (South Africa. National Treasury, 1994). The STC was notorious among companies and always had their disapproval (Katz Commission, 1996, p.23). STC was eventually decreased in fiscal 1996/97 to 12.5% and eventually to 10% in fiscal 2007/08, were it remained until 2009/10.

Discussions took place around the possible elimination, or at least reduction, of the STC, to reduce the burden of the combined corporate tax and minimize its distortions (Katz Commission, 1996, p.22) which would have decreased the effective tax rate on companies. It was perceived as a double tax because it was levied in addition to the corporate income tax. The tax rates were too high, both separately and combined, in comparison to tax rates in the countries of South Africa's trading partners.<sup>14</sup> Consequently, in fiscal 1996/97 STC went from 25% to 12,5% and nominal tax rate on companies dropped from 35% to 30% in fiscal 1999/00 and to 28% in 2008/09. This way the combined tax rate for companies was less distortive for the companies.

Companies were so averse to the STC, that the issues around its abolition or rate reduction remained topical even after the years of the Katz Commission (Sanlam, 2013). In addition, the STC failed to get international recognition, which made the taxation system for companies in South Africa out of line with international practice.

Since the establishment of the new democracy tax policy in South Africa had been shifting away from harmful tax practices (such as giving tax holidays and ring-fenced incentives<sup>15</sup> to foreign companies, which were unavailable to local companies) as a way of attracting foreign investment (Manuel, 2002, p.8). This was in accordance with government's plans to encourage investment through low tax rates instead of through selective tax incentives that distort the investment options, compromise the tax system's impact on economic efficiency and erode the tax base.

In 2009, the turnover tax was launched for small business with a turnover of R1 million or less, to simplify tax compliance and administrative burden for small businesses by reducing the number of returns that have to be filed (South Africa. National Treasury & SARS, 2010, p.11). It is levied on turnover not on profits (Cotten, 2012). It was launched as a parallel tax regime specifically for small businesses; interested small business could apply for it, otherwise the normal tax regime for normal companies was applicable.

Qualifying small businesses that opt to adopt this regime need to give in only one final return and two interim returns for evaluation. This saves them a lot of time and cost in submitting tax returns (SouthAfrica.Info: New Tax System for Small Firms, 2009). The turnover tax was

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<sup>14</sup> See Table 3.7 for a comparison of rates of company tax.

<sup>15</sup> Ring-fenced incentives are those where residents are prevented from benefiting, or non-residents may not access the domestic market (Weiner & Ault, 1998, p.604).

not designed as a relief, but merely as a measure to cut down on red tape and compliance costs<sup>16</sup>, boosting taxpayer morale and to permit informal sector businesses that do not keep proper books, to also pay tax. As discussed in Section 2.3.1 informal sectors are relatively large in some developing countries and the sectors are particularly hard to tax (Cotten, 2012). Under this tax, it is easier for the government to persuade the informal business sector into the tax net without having to burden them with compliance costs to the value of thousands of Rands.

In South Africa the tax incentives in place to attract foreign investment include incentives for energy efficient technologies in the form of supplementary depreciation allowances and incentives on natural resource sectors (South Africa. National Treasury, 2009, p.21).

Tax incentives are used to attract foreign investment all over the world and continue to drive economic policy in developing and developed countries (Calitz, Wallace & Burrows, 2013, p.3). They work by reducing tax liability either partially (deductions, preferred rates and exemptions) or completely, through tax holidays.

### *c) Capital Gains Tax*

CGT<sup>17</sup> was introduced in 2001 (South Africa. National Treasury, 2001a, p.1). According to the Katz Commission (1994) CGT could not be implemented in South Africa before, due to lack of administrative capacity. Also the Budget Speech stated that CGT was not applied before 2001 because the revenue authorities lacked the necessary administrative capacity, given the complexity of the tax (South Africa. National Treasury, 2000, p.18). CGT is a complex tax and can lead to high compliance costs for taxpayers and difficulties in administration (South Africa. National Treasury, 2001a, p.12). This is one of the main arguments against the application of this tax. However, Grote and Fletcher (2005, p.344) argue that not taxing CGT does not make the tax system simpler.

The main objective of CGT is to make income tax more equitable (South Africa. National Treasury, 2000, p.18). This is according to the principles of vertical and horizontal equity as discussed in Section 2.2.3. Just like any ordinary income, capital profits are economic profits and reflect an increase in net income (South Africa. National Treasury, 2000, p.18); therefore, owners of capital gains should bear the tax burden of this increase in income (Manuel, 2002,

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<sup>16</sup> See section 3.3.2.4 for compliance cost for business in South Africa.

<sup>17</sup> The base is the increase in value of assets such as real estate and shares (Katz Commission, 1996).



p.5). Following this concept, investors earning share gains must be subject to taxation, in the same way that employees that earn wages and salaries are subject to PIT (Manuel, 2002, p.5). This means that the tax should not discriminate between different types of income. CGT also conforms to the ability-to-pay principle which relates to vertical equity according to which higher incomes should be taxed differently (Grote & Fletcher, 2005, p.343). It is generally the relatively higher income earners that also make capital gains.

CGT was also introduced to enhance economic efficiency by decreasing distortions in investment decisions. Not taxing capital gains induces taxpayers into converting ordinary income into tax-free capital gains, which reduces their tax burden (South Africa. National Treasury, 2001, p.11).

Companies are required to pay CGT as part of CIT when they sell off assets. In order to maintain international competitiveness in 2010 corporate capital gains were levied at 14% (about half of the ordinary rate), whereas individual tax rates are based on a graduated scale of up to 10%, which is a quarter of the individual ordinary rate (SARS, 2010). For this same reason, the CGT regime introduced encompasses most of the exemptions found in international practice, for example exemptions for transfers between spouses, primary residence exemption, and exemption for involuntary disposals.

#### *d) Residence-based Income Tax*

South Africa started taxing its residents on a residence-base system in 2001 (Black, Calitz & Steenekamp, 2005, p.155). This meant that South African individuals and companies from that time were taxed on foreign-sourced income to the full weight of South African taxation. This was a consequence of globalisation. Due to globalisation there was substantial labour mobility and this led to loopholes in tax systems because labour mobility was not accounted for when the source-based system was used. Many South Africans would work abroad in countries like England which used the residence-based system while South Africa used the source-based system. These individuals working in such countries would then not be liable to pay personal income taxes either abroad nor in South Africa. The imposition of the residence-based principle closed this loophole. However, non-residents are taxed only their South African source income (South Africa. National Treasury & SARS, 2008, p.13).

Since the relaxing of exchange controls, South African businesses have become increasingly international and if the residence principle was not applied, companies and individuals would



operate abroad under false pretenses, just to avoid taxes (Katz Commission, 1997, p.18). Possible tax avoidance schemes included round-tripping schemes (RSA, 2001, p.88) in which taxpayers would acquire false deductions by shifting funds abroad to special purpose vehicles and bringing the funds back into South Africa tax-free (Manuel, 2002, p.6). This would in turn create equity and balance of payments concerns as it was unfair for some South Africans to be paying their taxes while others could avoid it and there could be significant tax revenue lost through these schemes.

Through the residence-based tax regime, income from foreign subsidiaries owned by South Africa also forms part of the South African tax net (South Africa. National Treasury & SARS, 2008, p.13). The case of income from foreign subsidiaries is more intricate and needs to be further reviewed or else South Africans will avoid this system of taxation by investing in wholly-owned foreign subsidiaries. (Manuel, 2002, p.6). For these reasons, all income diverted abroad through tax avoidance schemes, and passive income like dividends and interest, are subject to tax for being owned by a South African subsidiary.

### **3.2.2.3 Indirect taxes**

#### *a) VAT*

Following the recommendations from the Katz Commission, in 1996 the VAT base definition was broadened to include all financial services based on a fee, with the exception of retirement annuity, life policy premiums, medical aid funds and contributions to pension funds (South Africa. National Treasury, 2011, p.10). The inclusion of financial services allowed for greater vertical equity because the people who make use of financial services are usually the ones in higher income brackets, hence, making VAT more “progressive” or at least relieving some of its regressivity. The change also allowed for greater economic efficiency because all other services were taxed with the exception of financial services. This created distortions in the tax system.

The Katz Commission argued against rate differentiation to enhance the equity of the tax and suggested that changes regarding the increase in the standard VAT rate and narrowing of zero-rated items should be reviewed further (Katz Commission, 1996, p.9). During this period, the debate concerning zero-rating was still very much an issue, as requests for further zero-rating came forward from COSATU<sup>18</sup> (Jansen, Stoltz & Yu, 2012, p.5). Many

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<sup>18</sup> In addition to the basic foodstuffs, paraffin, an energy source used by many lower income households, was also exempted in 2001 (RSA, 2001, p.71).

governments argue that items which are predominant in low income households' budgets, like food, should be zero-rated (Tait, 1999, p 495). However, the provisions for exemptions, exceptions, deductions and adjustments erode the VAT liability and distort economic efficiency of the system. These provisions result in efficiency losses in a tax of which the impact on economic efficiency would otherwise have been close to that of a lump-sum tax.

Other exclusions included that small firms with a turnover of less than R300 000 per annum were not required to register for VAT (Go, *et al.*, 2004, p.7), and exports. Exempt services, such as rental of residential properties, are also not subject to VAT. Therefore, a vendor of zero-rated goods and services levies output tax at zero percent (South Africa. National Treasury & SARS, 2012, p.128).

#### *b) Taxes on International Trade and Transactions*

South Africa does not make much use of the custom duties as a revenue source as its contribution to total revenue is rather small.<sup>19</sup> The declining contribution of trade taxes to total tax revenue is apparent in middle-income countries all over the world (Glenday, 2008, p.5). In part this was due to implementation of the tariff reduction from the final act of the Uruguay trade negotiations in fiscal 1997/98 and the establishment of the World Trade Organization (WTO) (SARB, 2012, p.30).

#### *c) Excise taxes*

Excise taxes are levies devoted to specific activities which benefit the users or members of a particular group (Calitz & Siebrits, 2003, p.71). Excise taxes are applied on alcohol, tobacco products and fuel.

Sin Taxes: Alcohol and tobacco, also known as sin goods, are items to which excise duties are applied. These goods cause severe negative external effects to the public. Smoke in the air reduces the utility of the air to non-smokers and alcohol abuse may inflict physical and mental harm to third parties. The use of these sin goods also causes illnesses which increase rehabilitation and health provision costs to taxpayers. The use of tobacco and alcohol is also responsible for many road accidents and accounts for increased levels of criminal activities (Black & Mohamed, 2006, p.131).

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<sup>19</sup> The revenue from international trade consists mainly of customs duties (SARB, 2012, p.30).

As a measure to decrease the ‘sinful’ external effects governments apply taxes on these items, also known as sin taxes.

The policy decision of imposing a 50% tax burden of the retail price of tobacco products was imposed in 1996 (Manuel, 2002, p.10). Since then, excise tax increases have followed this trend. The increases are however limited due to the possible incentive to smuggle that it can create if prices are too high. Hence, government keeps it at a rate consistent with neighbouring countries (Manuel, 2002, p.10).

Excise taxes are levied on alcoholic beverages according to the beverage’s alcohol content and are adjusted on an annual basis. This leaves high-alcohol beverages more heavily taxed than low-alcohol beverages, according to local and international practice (South Africa. National Treasury, 1996, p.14). This is done to combat the abuse of alcohol (South Africa. National Treasury, 2010, p.14) whose negative external effect is very high.<sup>20</sup> This tax is therefore a type of Pigovian tax used to internalize the negative external impact of drinking.

#### *Luxury goods*

Ad valorem excises are applied in respect of luxury goods such as jewelry and sports cars. Taxing these goods at a higher rate enhances the progressivity of the tax system because those who make use of these goods are usually in the higher income groups. Thus it enhances the equity of the tax system.

#### *Fuel*

The fuel levy is currently taxed on the consumption of fuel by households and motor vehicles. It increases on an annual basis but the increases are below the expected inflation rate and linked to the high international oil prices (Manuel, 2002, p.21). In 2010, fuel taxes were increased to 25c/l (South Africa. National Treasury, 2010, p.14). Unlike the excise taxes on tobacco and alcohol, this tax was implemented to raise funds to cover the costs of road construction and maintenance and does not account for fuel’s environmental externalities (CEEPA, 2009, p.2). This means that the levy was introduced basically as a revenue-raising tool and not to internalize the negative externality which would have improved economic efficiency.

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<sup>20</sup> These negative effects include drunk driving and criminal activities which may frequently result in death.

#### **3.2.2.4 Tax treaties**

South Africa has treaty agreements<sup>21</sup> with the United States, Australia and Mauritius among others to promote investment in the country through administrative cooperation and information exchange (Hearson, 2012). The tax treaties could be more effective but until now there is not much evidence to suggest that it is fruitful in attracting foreign investment into the country.

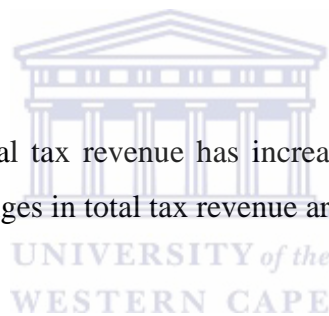
### **3.3 ECONOMIC APPRAISAL OF THE CHANGES TO THE SOUTH AFRICAN TAX SYSTEM BETWEEN 1990 - 2010**

The previous section focused on the most important changes to the South African tax system in recent years as well as the economic rationale behind them. The aim of this section is to investigate whether the intended objectives with these specific changes were actually achieved and to what extent.

#### **3.3.1 Revenue Raising**

##### **3.3.1.1 Total tax revenue**

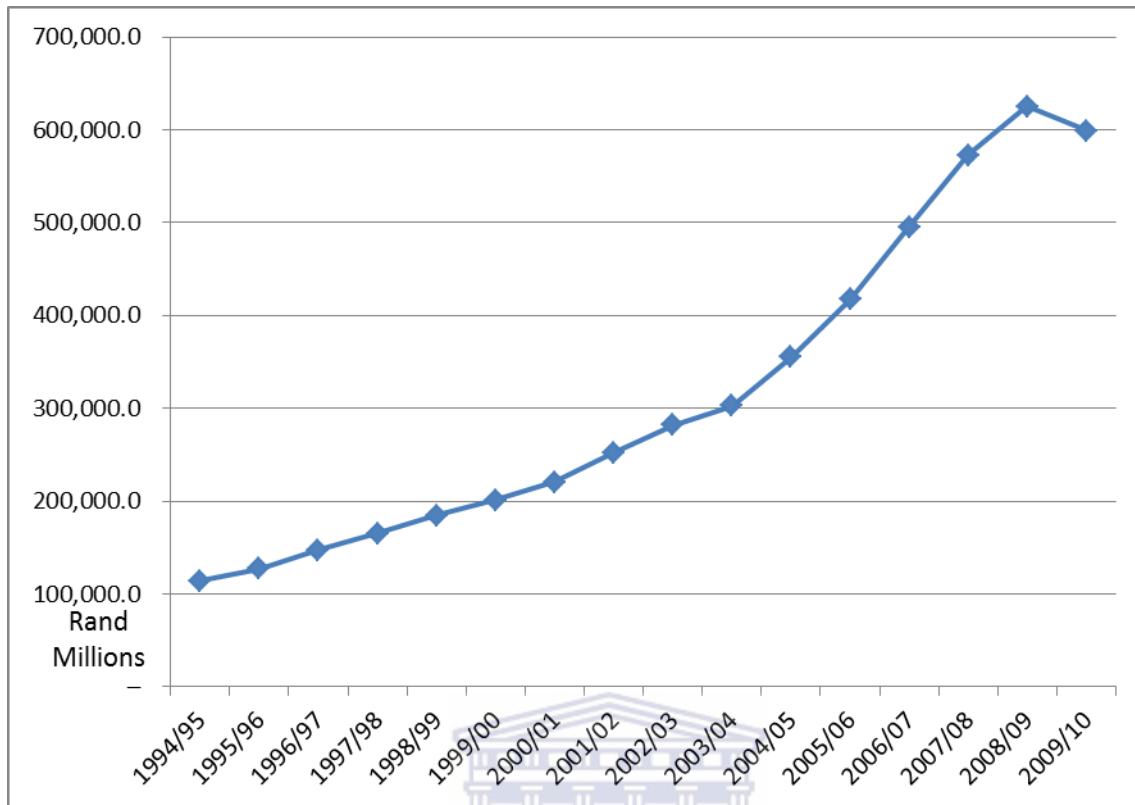
In South Africa, the level of total tax revenue has increased almost continuously after the establishment of SARS. The changes in total tax revenue are shown in the figure that follows:



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<sup>21</sup> Tax treaties establish maximum rates of tax that can be imposed by the source country on certain categories of income to residents of the other country it enters into, to mitigate the effects of double taxation.

**Fig 3.1.Total Tax Revenue in South Africa from 1994 - 2010**



Source: Adapted from South Africa. National Treasury & SARS (2008, p.4) and (2010, p.2)

Note: Earlier tax statistics not available from SARS. Data is given in nominal values.

From the above figure, it is evident that total tax revenue increased throughout up to 2008/2009. The taxing of fringe benefits and the closing of many loopholes related to income taxes could have made a contribution during the first phase. Total tax revenue also grew faster from the time SARS was implemented until the fiscal year 2009/10. The relatively stronger growth in tax revenue from the year 2003/04 is clear from figure 3.1. This fast increase in total tax revenue occurred because fiscal 2002/03 was a period of strong economic growth and also because major reforms were implemented, namely capital gains become taxable in 2001 and the source-based method of taxation was changed to residence-based. This stimulated strong revenue growth in the following years as is reflected in the above figure, and even allowed government to provide some tax relief.

Tax collections increased on average by 13.2% between 2000 and 2008, it decreased between 2008 and 2010 due to the economic contraction caused by the global financial crisis (Charalambous, 2012). The global financial crisis resulted in decreased domestic production, decreased demand and falling exports (SARB, 2013, p.23).

### 3.3.1.2 Components of total tax revenue

#### Direct taxes

The table below shows the contribution of income taxes to total tax revenue:

**Table 3.5 Components of total tax revenue (PIT, CIT & STC) 1994 - 2010**

Years	Personal income tax (PIT)		Corporate income tax (CIT)		Secondary tax on companies (STC)	
	Total tax Revenue	%	Total tax Revenue	%	Total tax Revenue	%
1994/95	44,973	40%	11,961	11%	1,304	1%
1995/96	51,179	40%	14,059	11%	1,262	1%
1996/97	59,520	40%	16,985	12%	1,338	1%
1997/98	68,342	41%	19,696	12%	1,446	1%
1998/99	77,734	42%	20,388	11%	1,931	1%
1999/00	85,884	43%	20,972	10%	3,150	2%
2000/01	86,478	39%	29,492	13%	4,031	2%
2001/02	90,390	36%	42,355	17%	7,163	3%
2002/03	94,337	33%	55,745	20%	6,326	2%
2003/04	98,495	33%	60,881	20%	6,133	2%
2004/05	110,982	31%	70,782	20%	7,487	2%
2005/06	125,645	30%	86,161	21%	12,278	3%
2006/07	140,578	28%	118,999	24%	15,291	3%
2007/08	168,774	30%	140,120	25%	20,585	4%
2008/09	195,115	31%	165,378	27%	20,018	3%
2009/10	205,145	34%	134,883	23%	15,468	3%

Source: South Africa. National Treasury & SARS (2008, p.16) and (2010, p.39).

Note: Earlier tax statistics not available from SARS

It is evident from the table that in comparison to CIT, PIT remained a major contributor to tax revenue in South Africa over the whole period. During the period of the first phase of tax reforms, it contributed more than 40% of total tax revenue. Interestingly enough PIT's relative contribution to total tax revenue did not decrease during the financial crisis period 2008/09. In earlier years, PIT's contribution was higher; the decrease in its contribution to total tax revenue can be attributed to the lowering of the MTRs. The relative contribution of CIT & STC to total tax revenue has increased over the years.

*Indirect taxes*

**Table 3.6 Components of total tax revenue (VAT, Fuel, Customs & Excises) 1994 - 2010**

R million	VAT		Fuel levy		Customs		Specific excise duties	
	total tax Revenue	%	total tax Revenue	%	total tax Revenue	%	total tax Revenue	%
1994/95	29,288	26%	8,352	7%	5,606	5%	5,431	5%
1995/96	32,768	26%	8,928	7%	6,170	5%	6,075	5%
1996/97	35,903	24%	10,392	7%	7,201	5%	5,912	4%
1997/98	40,096	24%	12,091	7%	5,639	3%	7,426	5%
1998/99	43,985	24%	13,640	7%	6,053	3%	8,053	4%
1999/00	48,377	24%	14,290	7%	6,778	3%	8,886	4%
2000/01	54,455	25%	14,495	7%	8,227	4%	9,127	4%
2001/02	61,057	24%	14,923	6%	8,680	3%	9,797	4%
2002/03	70,150	25%	15,334	5%	9,620	3%	10,423	4%
2003/04	80,682	27%	16,652	6%	8,414	3%	11,365	4%
2004/05	98,158	28%	19,190	5%	12,888	4%	13,067	4%
2005/06	114,352	27%	20,507	5%	18,303	4%	14,547	4%
2006/07	134,463	27%	21,845	4%	23,697	5%	16,369	3%
2007/08	150,443	26%	23,741	4%	26,470	5%	18,218	3%
2008/09	154,343	25%	24,884	4%	22,751	4%	20,185	3%
2009/10	147,941	25%	28,833	5%	19,577	3%	21,289	4%

Source: South Africa. National Treasury & SARS (2008, p.16) and (2010, p.39).

Note: Earlier tax statistics not available from SARS.

It is evident from Table 3.6 that there has been a general decrease in revenue from trade taxes over the years. There was a slight growth in revenue from trade taxes between 1995/96 and 1996/97 due to double digit increases in custom duties (SARB, 2013, p.30). However, from 1997/98, the revenue from trade taxes in South Africa fell sharply following South Africa's implementation of tariff reductions as agreed in the Final Act of the Uruguay Round of Trade Negotiations and in the Marrakesh Agreement which established the World Trade Organization (WTO) (SARB, 2013, p.30).

Revenue from trade taxes increased between the periods of 2004 to 2007 due to high demand for imports and decreased again from 2008 to 2010 due to a drop in demand for imports caused by the international financial crisis in 2008 (SARB, 2013, p.30).

Nevertheless, South Africa has been able to offset this low revenue from import duties with revenue from VAT (Glenday, 2008, p.5). It is evident from Table 3.6 that VAT has been



increasing steadily since 1994/95. It showed a decline only in 2008/09 due to the global financial crisis in 2008/09.

Revenue from excises has also shown a decline from the start of the period to the end. This could be due to a general decrease in the consumption of tobacco products (Van Walbeek, 2005, p.10) or it could be a result of increased smuggling due to the increase in the excise rates (Van Walbeek, 2013, p.1).

### **3.3.2 Administrative Efficiency**

#### **3.3.2.1 Contribution of SARS**

The enactment of SARS has not only set the foundation for better compliance and administration of tax laws and tax collection to the point of broadening the tax bases and improving compliance. This can be deduced from the increase in the collection of tax revenue over the years (Charalambous, 2012). There is however, no current public data available to analyse SARS's single effect on South Africa's revenue performance (Glenday, 2008, p.1).

From the above, it is safe to say that the implementation of SARS has enabled the achievement of the revenue-raising objective of the tax reforms. SARS collected R113.8 billion in national tax revenue in 1994/95 (nominal values) which increased to 598.705 billion in 2009/10, a 500% increase over this period (South Africa. National Treasury & SARS, 2010, p.1). The Minister of Finance between 1997 and 2009, Mr. Trevor Manuel (2002, p.4) claimed that SARS can easily be considered the most significant contribution to fiscal stabilization in the country. SARS achieved significant efficiency gains during and after the reform years due to better compliance and administration of tax laws (SARB, 2013, p.24).

Another factor that enhanced the administrative efficiency of the tax system is the accessibility of SARS' services. Individuals are able to file their returns online and there are SARS mobile "offices" on the streets<sup>22</sup>. They provide customer assistance both online and at the offices. This modernization has made them more customer-friendly and has increased tax compliance significantly (Charalambous, 2012).

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<sup>22</sup> The e-filing system was introduced by SARS in 2001



### **3.3.2.2 Evasion, avoidance and penalties**

Despite the increased administrative efficiency since the establishment of SARS, the extent of evasion and avoidance by individuals and companies is still very high and has become more sophisticated (South Africa. National Treasury, 2010, p.15). This confirms Maroun, Turner and Sartorius' (2011, p.439) argument that the tighter the tax nets, the more creative the method of avoidance and evasion of taxes. This has become such a reality in South Africa that it became mandatory for all who earn an income, including the ones below the tax threshold, to be registered with SARS since 2010 (South Africa. National Treasury & SARS, 2011, p.2). This way SARS can keep track on their activities in case of any tax evasion or avoidance. However, there are no available figures in South Africa that measures the tax gap, but it is estimated to be between 15% and 30% of the collected tax (Carolissen, 2010, p.9).

Tax evasion is exacerbated also because South Africa's income tax laws limit tax authorities' discretion to publish taxpayers' income details to safeguard the confidentiality and privacy of the tax payer except under specific circumstances (Phua, 2012, p.27). The penalty systems implemented by SARS were not effective as a deterrent for non-compliance (South African Government News Agency, 2009). It was so ineffective that more than 5.3 million returns were outstanding in fiscal 2007/08 and legal action had to be made against 81,000 taxpayers. In 2009 a stricter new penalty system was imposed providing for recurring penalties on a monthly basis each time there is an outstanding income tax return (South African Government News Agency, 2009). Penalties for tax evasion reinforce the cost of noncompliance and encourage voluntary compliance. High penalties can deter future abuses of the tax system (Phua, 2012, p.29).

Also, the decrease in nominal tax rates for companies and MTRs for individuals decreased the opportunity and possible gains from tax arbitrage, which occurs when trading takes advantage of differences within or between national tax codes in order to profit (Feetham, 2011, p.5). It can be speculated that with the closing of loopholes mentioned in Section 3.3.1.1 narrowed the taxpayers' opportunities for tax evasion.

Tax amnesties<sup>23</sup> were launched, including in the informal sector, to improve the informal sector's contribution (Gcabo, 2007, p.357). This provision brought more taxpayers into the

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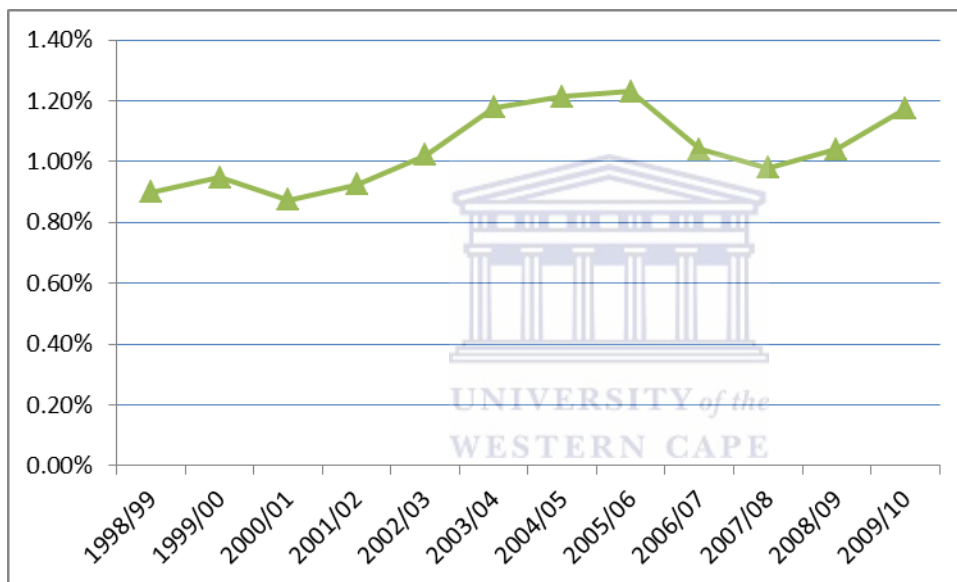
<sup>23</sup> The opportunity, within a limited period, to disclose unreported information relating to previous reporting period, without incurring criminal charges.

net and improved taxpayers' morale. The provision also brought down the extent of evasion and avoidance.

### 3.3.2.3 Administrative costs

A very important measure of the efficiency of tax administration is the cost of revenue collection, which measures the efficiency at which revenue is collected. It is measured by calculating the cost of internal operations as a percentage of total tax revenue and is the international benchmark to measure administrative efficiency. International practice states that ideally this ratio should be at 1% of administration costs (South Africa. National Treasury & SARS, 2012, p.5).

**Figure 3.2 Operating cost as a % of tax revenue**



Source: Adapted from South Africa. National Treasury & SARS (2008, p.28) and (2010, p.6)

Note: Earlier tax statistics not available from SARS.

From the figure above it is evident that cost of revenue collection has been relatively stable from the years 1998/99 to 2002/03. After that period it had increased to its highest ratio of 1.23% in 2005/06. It can be speculated that this could be due to the implementation of the CGT in 2001 which is a rather complex tax to administer, as well as the change from source-to residence-based taxation in the same year. It could be that it might have taken some time for staff to learn to easily administer such taxes and this might have led to an increase in the cost of revenue collection. In the year 2009/10 the cost of revenue collection ratio increased to 1.2% because of the global financial crisis which lowered revenue collections without the possibility of a downward adjustment in cost structures within SARS (South Africa. National Treasury & SARS, 2012, p.5).

#### **3.3.2.4 Tax compliance and taxpayer morale**

A study by Cummings *et al.* (2006, p.23), concluded that tax compliance in South Africa is relatively low. This could be because the sanctions for non-compliance are not harsh enough, or that the mechanisms to follow up on it are not effective, or due the social and political history of the country. Minister of Finance, Pravan Gordhan, claimed that SARS are now able to audit with accuracy as a result of improved staff and have harsher penalties for tax evasion schemes (South Africa. National Treasury, 2010, p.5). According to previous SARS Commissioner Oupa Magashule,<sup>24</sup> tax compliance has increased since 1994 due to the increase in the number of registered tax payers which rose from 1.7 million in 1994 to 6 million in 2010 (Charalambous, 2012). However, Mugashule noted that compliance by companies is low (Charalambous, 2012).

It can be assumed that taxpayers were positively influenced by the lower tax rates and tax relief granted over various years and that they would be more willing to declare their personal income.<sup>25</sup> Therefore lower tax rates would have boosted taxpayer morale and is helpful in reducing tax avoidance and evasion, which should result in higher levels of tax revenue. This is in line with Bird's (2010, p.6) contention that tax levels should reflect the taxpayers' perception of the quality and responsiveness of the state.

#### **3.3.3 Economic Efficiency**

Economic efficiency can be considered by looking at the various aspects of the tax reforms which could have impacted on the excess burden.

##### **3.3.3.1 Broadened tax base**

The economic efficiency of the tax system was promoted by the broadening of the tax base that took place during both phases of tax reforms in South Africa. During the first phase, as discussed in Section 3.2.1, various fringe benefits were brought into the base of personal income tax which closed many loopholes that were previously exploited by taxpayers. In the case of company tax the introduction of STC also broadened the tax base.

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<sup>24</sup> Oupa Magashule was Commissioner of SARS from 2009 until his resignation in July 2013.

<sup>25</sup> This is according to the so-called Laffer effect according to which "higher tax rates will not necessarily produce more tax revenue, since the tax base will shrink as taxpayers reduce their work effort in response to the higher tax rates" (Black *et al.*, 2011, p.217.)

During the second phase the base of VAT was broadened to include all financial services based on a fee (See Section 3.2.2.2.d.). Capital gains tax and the introduction of the residence principle also made income from a foreign source taxable under PIT and CIT.

### **3.3.3.2 Income taxes**

#### *a) PIT*

In general, the decrease in marginal rates of personal income tax means that the tax system has become more efficient because the theoretical excess burden decreases more than proportional to the decrease in the tax rate. This reform was necessary because of the increasing globalisation of the economy and the drive towards tax harmonization. It forced South Africa to review the competitiveness of its marginal rates of PIT in the face of the brain drain it faced, as a means of preserving its skilled labour force.

Taxing fringe benefits under PIT also closed important loopholes in the system and allowed for greater economic efficiency due to improved neutrality. This put a stop to the preferential treatment of individuals who were in a position to receive fringe benefits, such as overseas holidays, because it is the higher income earners who get fringe benefits.

The elimination of formal gender discrimination with the imposition of a single tax rate structure on all individuals, irrespective of gender or marital status, enhanced the efficiency of the South African tax system. That is because the higher tax rates on married women compromises economic efficiency as the MTR is responsible for the substitution effect. Due to this effect, women might have decided not to participate in the labour market and it might have affected their saving behaviour. According to Budlender, Casale & Valodia. (2010, p.209) this reform has led to an increase in the participation of women in the labour force, although there are fewer women in the labour force in comparison to men.

The highest marginal rates of PIT in countries with similar economic circumstances to South Africa like the United Kingdom, Germany and Brazil have also shown a decrease between 1990 and 2010. In Brazil the highest MTR by 2010 was 27.5%, in Germany it is 45% and had actually increased from 42% in 2006; and in the UK it is at 50% increasing from 40% in 2009 (KPMG, 2013). Although comparing well to the UK and Germany, South Africa is in a worse position compared to Brazil, a country also classified as an emerging market economy. Compared to other countries South African tax rate is rather high: 20% in Egypt; 25% in Uruguay; 28% in Malaysia and 13% in Russia. This raises other questions like whether the

top MTR of South Africa is low enough to attract highly skilled workers into the country. Glenday (2008: p.8) is of the opinion that South Africa's top MTR is reasonable when compared to OECD countries where the top marginal rates range from 19% to 59.7%.

Considering an increase in the rate of PIT for the taxpayers in the higher tax brackets for redistributive purposes was not feasible, because they are very sensitive to increases in tax rates (they could emigrate, evade taxes, work fewer hours, retire early etc.), which could significantly affect tax revenue and economic efficiency (Steenekamp, 2012b, p.13). This conforms to the findings of Hagemann, Jones & Montador, (1988, p.187) that increases in labour taxation leads to decreases in labour supply because the after-tax return to the worker is less than the cost to the employer, driving a wedge between the before- and after-tax returns. This clearly shows the complexity of tax policy in terms of the tradeoff between the principles of equity and efficiency.

*b) CIT*

The reductions in corporate tax rates and the STC decreased the excess burden on companies and made these taxes more efficient.

Another very important reform to improve economic efficiency of the tax system was the effort to bring the highest marginal rate of PIT in line with the nominal rate of company tax. This reform is in accordance with second lesson from conventional wisdom as stated by Musgrave (See Section 2.3.2.3). The lesson is that the rate of CIT should not be lower than the highest marginal rate of PIT. If it were lower, individuals would exploit the opportunity for tax arbitrage and form companies to benefit from the lower tax rate.

**Table 3.7 Comparing top MTR and Company tax rates 1990 - 2010**

<b>Year of Assessment</b>	<b>Flat rate on taxable income %</b>	<b>Rate of STC</b>	<b>Top Marginal Tax Rate on Personal Income</b>
1990/91	50	-	44
1991/92	48	-	43
1992/93	48	-	43
1993/94	40	15	43
1994/95	35	25	43
1995/96	35	25	45
1996/97	35	12.5	45
1997/98	35	12.5	45
1998/99	35	12.5	45
1999/00	30	12.5	45
2000/01	30	12.5	42
2001/02	30	12.5	42
2002/03	30	12.5	40
2003/04	30	12.5	40
2004/05	30	12.5	40
2005/06	29	12.5	40
2006/07	29	12.5	40
2007/08	29	10	40
2008/09	28	10	40
2009/10	28	10	40

Source: SARS, (2012, p.12-22) & SARB (2012, p.90)

As is clear from Table 3.7 above, from the fiscal year 2000/2001 the rates of PIT and CIT stayed close together. During the first phase of tax reform, when the flat rate of company tax was much higher than the top marginal rate of PIT, it should also be kept in mind that the effective rate of company tax at that time was much lower than the nominal rate.

Because the flat rate of company tax was brought down through these phases of tax reform and also because the STC was being phased out, the possible excess burden improved more than proportionally. These reductions brought the tax rate on companies in South African also more in line with tax rates in the countries of its trading partners. As explained earlier, globalisation caused greater mobility of skill and capital and it was important to make tax changes in accordance with international tax practice. Section 2.3.2.3 also referred to Musgrave's second lesson, reinforced by globalisation, according to which tax rates in

countries that are dependent on foreign capital, should not be higher than in countries that export the capital.

Table 3.8 compares the rate of CIT in South Africa to the rates in countries that are major exporters of capital to South Africa.

**Table 3.8 Top company rates for the United Kingdom, United States, Germany and South Africa**

<b>Year of Assessment</b>	<b>UK</b>	<b>US</b>	<b>Germany</b>	<b>South Africa</b>	<b>Rate of STC (SA)</b>
	%	%	%	%	
1990	34	34	50	50	
1991	33	34	50	50	
1992	33	34	50	48	
1993	33	35	50	48	15
1994	33	35	45	40	25
1995	33	35	45	35	25
1996	33	35	45	35	12.5
1997	31	35	45	35	12.5
1998	31	35	45	35	12.5
1999	30	35	40	35	12.5
2000	30	35	40	30	12.5
2001	30	35	25	30	12.5
2002	30	35	25	30	12.5
2003	30	35	26.5	30	12.5
2004	30	35	25	30	12.5
2005	30	35	25	30	12.5
2006	30	35	25	29	12.5
2007	30	35	25	29	10
2008	28	35	15	29	10
2009	28	35	15	28	10
2010	28	35	15	28	

Source: CESIFO, 2013 and SARB (2012, p.90)

Table 3.8 illustrates the trend of decreasing rates of income tax on companies, except for the case of the US where the rates remains relatively stable. However, what is clear from the table is that when STC is included, the rate of company tax in South Africa, as a capital-importing country, is much higher than the rate in countries that are the traditional exporters of capital to South Africa. From 2010 the situation looks much better and the South African position is much more competitive. Although other factors such as profitable opportunities



are much more important to attract foreign investment flows the tax increased the relative cost of doing business in South Africa.

Over the years, as explained in Section 3.2.2.2 (b) various tax incentives were also introduced to support the corporate sector. These incentives, such as for the automotive industry, were intended to support specific industries and to strengthen the potential for longer-term growth. However, tax incentives distort economic decisions and increase the excess burden (Kransdorff, 2010, p.78). That is because some activities will be pursued more than others not because of their competitive advantage, but because their profitability is artificially enhanced due to the incentives. In South Africa's the motor industry has lived this dilemma. It has cost government about R700 000 million to maintain the viability of the sector when this money could have been invested in more productive projects (Kransdorff, 2010, p.78). Tax incentives, although they may serve important purposes, have decreased the economic efficiency of the South African tax system.

#### *c) CGT*

As discussed earlier in Section 3.2.2.2 (c) the introduction of CGT made the system more efficient because it decreases investments distortions (South Africa. National Treasury, 2001, p.4). According to Black *et al* (2008, p.182) the introduction of CGT was an important step to protect the "integrity of the personal income tax". Not taxing capital gains encouraged individuals to invest their savings in assets that gave returns of capital gains instead of income-producing assets like machinery and equipment. This would in turn lead to the misallocation of resources (South Africa. National Treasury, 2001, p.11). Therefore, the introduction of capital gains in South Africa has ruled out the differential tax treatment of different assets thus increasing economic efficiency. However it can also be argued that the CGT decreases the economic efficiency of the South African tax system because it results in decreases in economic growth by decreasing investments and savings which encroach on entrepreneurial activity and risk-taking.

Even though the revenue from CGT can be relatively small, CGT acts as a backstop to the income tax (Steenekamp, 2011, p.41). From the time of its inception, CGT has managed to collect R27 074 million Rands.



In 2009/10 government collected of 4.4 billion Rands in revenue, about 2.1% of taxes on persons and individuals (Steenekamp, 2012a, p.43). It was a huge attempt because the appreciation on all investment assets was fully untaxed.

### **3.3.3.3 Indirect taxes**

#### *a) VAT*

VAT is considered an efficient tax, because it does not distort consumer choices. However, zero-rating of basic foodstuffs, which was intended to make the tax less regressive, renders the tax less efficient as it may distort consumer choices. Consumers may choose to increase their consumption of the zero-rated items just to enjoy the cheaper prices.

In addition, the potential increase in the VAT rates also causes distortions because increasing the tax rates may create incentives to purchase in neighbouring countries where the rate is lower, although this problem is being addressed through international tax treaty obligations.

#### *b) Excises*

The sin taxes on cigarettes and alcohol are Pigovian taxes imposed to internalize the negative external impact on the community by using these products. Taxing the ‘sinners’ is supposed to internalize the negative externality by increasing prices which is supposed to discourage the use of these harmful products. In this way sin taxes will enhance economic efficiency. But, the demand for these products is probably relatively inelastic, which means that the excess burden would be relatively smaller, and according to the inverse-elasticity rule<sup>26</sup> this would also increase economic efficiency.

On the other hand, Black and Mohamed (2006, p.136) claimed that sin-taxes can be seriously distortive, which negatively affects economic efficiency. They argued that “... “sin” tax hikes may adversely affect the welfare of household members other than the head, either directly through a re-allocation of the household budget, or indirectly through higher health expenses caused by the substitution of cheaper and lower quality alcohol and tobacco products for higher quality products.” These distortive effects should be a serious matter of concerns in South Africa given the extent of addiction under some poorer communities.

Increases in the excise rates for luxury goods are also distortive because it shifts consumption away from luxury goods due to the high prices.

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<sup>26</sup> See Section 2.2.1

Last, increases in the fuel levy may be distortive causing the individual to decrease the consumption of fuel. However it is also efficient in that although its main aim is not to account for its negative environmental effects, the decrease in consumption would reduce the amount of air pollution from gas emissions from cars. However, a study by Mabugu, Chitiga and Amusa (2009, p.291), shows that the welfare effects of increasing the fuel levy to account for environmental externalities is rather insignificant. In order to internalize the environmental effects caused by fuel consumption, it is not enough to just increase the fuel levy. The industry and agriculture sectors need to be included in the environmental policies aimed at reducing pollution (CEEPA, 2009, p.4).

### **3.3.4 Equity Considerations**

As discussed in Section 3.2 various reforms since the 1990s were supposed to enhance the impact of the South African tax system on income distribution. Calitz & Siebrits, (2003, p.70) mentioned that according to a study by the Department of Finance, overall the South African tax system is progressive. The study analyzed the incidence of PIT, VAT, excise duties and fuel levy, and found out that the lowest income earners spend 11% of their income on these taxes, compared to the richest that spend up to 30%.

The following sub-sections discuss the impact on income distribution of the individual taxes.

#### **3.3.4.1 Income taxes**

##### *a) PIT*

In South Africa, PIT is progressive and is based on the ability-to-pay principle (Black *et al*, 2005, p.169). This is fair on the grounds of vertical equity. An empirical study by Steenekamp (2012a, p.44) shows that PIT was less progressive between 1997 and 2000 and then the extent of progressivity increased between 2000 and 2009 (Steenekamp, 2012a, p.47). However, a study by Nyamongo and Schoeman (2007, p.487) revealed mixed results on the equity impact of PIT. Using the Musgrave and Thin method, they found that there was a decline in progressivity from 1994 to 2004, whereas when using the Kwakwani method it showed that there was a significant increase in progressivity between 1994 and 2000 and then a decrease was apparent between 2000 and 2004 due to the application of the tax reforms. The results are rather mixed in evaluating the extent of progressivity of PIT in South Africa.

The imposition of a single tax rate structure on all individuals, irrespective of gender or marital status, enhanced the equity of the South African tax system by eliminating explicit formal gender discrimination (Valodia & Smith, 2001, p.29).

It was mentioned earlier that fringe benefits became taxable. Therefore, the taxation of fringe benefits enhanced vertical equity because the richer, that had more ability to pay, were being taxed based on the benefit principle of equity. They enjoyed the use of company benefits without paying tax. Taxing these fringe benefits made the tax system more equitable.

The high revenue collection from fiscal year 2002/03 onwards allowed the government to grant substantial relief to taxpayers with R44.4 billion accruing directly to individuals between the 2007/08 and 2011/12 periods (South Africa. National Treasury & SARS, 2012, p.3; SARB, 2013, p.21). Tax relief was granted especially by decreasing PIT rates. Significant tax relief in real terms was provided to low- and medium-income taxpayers. The tax relief to individuals in these income groups counteracted the impact of bracket creep, which occurs when incomes increase with inflation whereas tax thresholds are left unchanged, putting these individuals on higher tax brackets and reducing after-tax income in real terms.

This relief impacted positively on income distribution. However, it did not reach the really poor. They did not benefit from the tax relief under the PIT, as their incomes are below the tax threshold and consequently, they do not pay tax. The tax thresholds have been increasing steadily since the beginning of the period under study. This allowed for greater equity because people who are poor should stay out of the income tax net, and this was achieved by keeping them below the tax threshold.

Duncan (2011) claims that after the financial crisis of 2008/09, there will need to be an increase on the taxes of the richer in the years to follow to push up the “redistributive thrust of the budget”. In addition, the most affected taxpayers (the rich) enjoy very little of the benefits of paying such high taxes as most make use of private schools, health and security services (Duncan, 2011).

#### *b) CGT*

Capital gains tax made the system more equitable according to both vertical and horizontal equity as well as on the ability-to-pay and benefit principles, as referred to in Chapter Two. That is because people with a greater ability to pay, in this case the owners of the capital

gains, should bear a relatively higher burden of tax. Otherwise, these owners of capital gains would be paying just as much as the middle- or low-income earner, while having a higher income than them, rendering the system less progressive (South Africa. National Treasury, 2001, p.10). In opposition to this, Vivian (2006, p.84) adds that it is not enough to have the ability-to-pay, taxpayers need to have the ability-to-bear the burden of taxation. The state should have a balance between its revenue-raising objective and the right of the individual to survive (Maroun, 2011, p.438). The concept of vertical equity in CGT undermines the concept of what is economically efficient. It is not enough to quantify the ability-to-pay as a feasible justification for the application of CGT.

Vivian (2006, p.84) argues that the CGT is also an unfair tax, because the individual is taxed on income and on capital. He points out that since personal income is already taxed, all other taxes that are paid from after-tax income is a form of double taxation. He adds that taxes should be on income and not on capital and that income that is of a capital nature should be subtracted from total income.



### **3.3.4.2 Indirect taxes**

#### *a) VAT*

VAT is a regressive tax because people at lower income levels pay a higher percentage of their incomes in terms of VAT. The addition of financial services to VAT in 1996, made the tax less regressive, because richer people are the ones that use services relatively more often than the poorer population. This improved vertical equity in the tax system because the wealthier citizens who made use of financial services were being taxed according to the ability-to-pay principle as the rich have higher abilities.

According to Jansen, Stoltz and Yu (2012, p.1) possible increases in the rate of VAT was seen as unfair according to the strong resistance of the Congress of South African Trade Unions (COSATU). COSATU went as far as requesting that tinned foods be zero-rated as well to further counteract the regressivity of the tax. The Katz Commission (1996, p.9) was investigating a possible increase in the standard VAT rate and also the possibility of differential rates to allow for greater equity. The Commission decided against differential rating due to lack of administrative capacity in SARS.

The provision for zero-rating on some basic foodstuffs is allowed in order to help the poor, in an attempt to reduce the regressivity of VAT. However, according to National Treasury &

SARS (2008, p.117) only a third of the total amount of foregone revenue from zero-ratings benefits the bottom half households in the income distribution. Therefore, according to the South African government, no further foodstuffs will be zero-rated in South Africa (RSA, 2008, p.42).

Logically, richer households gain more in absolute terms as they spend more, as pointed out by Jansen, Stoltz and Yu (2012, p.21). However, to determine the impact on equity, it is the relative position that needs to be considered. Jansen, Stoltz and Yu (2012, p.16) add that zero-rating decreases the VAT burden of the lower income households by 18%, whereas it decreases the burden of the highest income groups by 6%. They also investigated whether the zero-rated basket is optimally targeted. They focused on vegetables as a food category and found that vegetables can be divided into fresh (basic and luxurious types), frozen and tinned. According to their findings frozen vegetables should remain zero-rated, tinned vegetables that are presently taxed should be zero-rated and luxurious fresh vegetables should also be taxed at the standard rate. They concluded that the zero-rating can be improved by targeting foodstuffs that are used proportionally more by poor households. They also reiterate the recommendations by the Katz Commission (1996, p.9) and by Cnossen (2003, p.3) that zero-rating should be regularly reviewed in order to optimally benefit the poor (Jansen, Stoltz and Yu, 2012). VAT thus remains an unpopular tax that which is perceived as unfair. Glenday (2008, p.5) agreed, stating it is unlikely that there will be any significant increases in VAT in the medium term in light of COSATU's strong opposition to this change, which means that it will not be politically responsible to increase the rate.

Increasing the VAT rates and/or eliminating zero-rates would not be a feasible move for the government, both politically and economically. This would reduce their political favour among voters and cause further resistance to reforms of this nature.

#### *b) Excise Taxes*

An empirical study by CEEPA (2009) concluded that although adding an additional amount to a sin tax, like an environmental tax for fuel, is feasible in reducing the fuel consumption and the pollution from its consumption, sin taxes like a fuel levy are regressive because the people at lower incomes pay a relatively higher part of their incomes in terms of the tax.

There are mixed views regarding the increase in the fuel levy. First, as already mentioned, it is regressive. CEEPA (2009, p.3) goes further to state that such a tax would not impose an

unfair burden on the poor and can actually be progressive because the percentage of household income spent on fuel increases as total household expenditures increase.

### 3.3.5 Macroeconomic Considerations

#### 3.3.5.1 Total tax burden

**Table 3.9 Tax revenue as % of GDP**

<b>Fiscal Years</b>	<b>% of GDP</b>
1994/95	<b>22.9%</b>
1995/96	<b>22.6%</b>
1996/97	<b>23.2%</b>
1997/98	<b>23.6%</b>
1998/99	<b>24.4%</b>
1999/00	<b>24.1%</b>
2000/01	<b>23.2%</b>
2001/02	<b>24.1%</b>
2002/03	<b>23.5%</b>
2003/04	<b>23.5%</b>
2004/05	<b>24.9%</b>
2005/06	<b>26.3%</b>
2006/07	<b>27.4%</b>
2007/08	<b>27.8%</b>
2008/09	<b>27.0%</b>
2009/10	<b>24.5%</b>



Source: South Africa. National Treasury and SARS (2008, p.17) and (2010, p.39)

Note: Earlier tax statistics not available from SARS.

As can be seen from Table 3.9, the total tax burden has gradually increased over the period of review, except for the fiscal year 2009/10. Duncan (2011) claimed that only 12% of South Africans pay tax, but 30% receive social grants. According to him the rich are too heavily taxed and the poor are taxed too lightly. Sanlam Chief Economist Laubscher (2013) agrees that the tax burden in South Africa is already too high and mentioned that the burden is likely to increase, considering the present fiscal stance (Laubscher, 2013). A too high tax burden may negatively affect the perception of foreign investors. Laubscher (2011) previously suggested that the fiscus should avoid tax rate increases and rather focus on managing

government expenditure. De Waal (2009) mentioned that public service employees should be encouraged to accept salary increases below the inflation rate.

### **3.3.5.2 Foreign direct investment**

Tax arrangements and changes may impact on FDI flows. Did the tax reforms in South Africa have a positive impact on the much needed FDI flows? Calitz, Wallace and Burrows (2013, p.21) concluded that in South Africa a reduction in the corporate tax rates would be more effective in attracting foreign investment than the tax incentives already in place, because these have failed to bring foreign investment into the country.

In South Africa tax incentives have not been successful in attracting foreign investment (Kransdorff, 2010, p.78). Duncan (2011) argues that government should rather decrease the bureaucracy as well as the minimum wage because red tape and high minimal wages shift activities into the informal sector. This makes one think that in the case of South Africa, Bird (2008, p.8) was right in concluding that tax incentives are generally a bad idea. One of the reasons is because the tax policy in place is not competitive (Kransdorff, 2010, p.74).

A different example in South Africa is the automotive industry which received much government support through a group of incentives known as the Motor Industry Development Programme (MIDP). This industry is particularly successful due to high amounts of incentives from government. Although it can be argued that the effects of incentives diminish with time, it is unlikely that incentives of this proportion do not affect the choices of investors (Oxfam, 2013).

### **3.3.5.3 Economic growth**

With regards to the impact of the tax reforms on economic growth, Koch, Schoeman and Van Tonder (2005, p.208) concluded that South Africa's approach to economic growth by lowering tax rates and broadening the tax base could pay economic dividends, which may be mitigated by the improvements in tax collections. The authors add that recent decreases in income taxes should result in a decreased tax burden.

Following the financial crisis, the tax relief to the amount of 6.5 billion Rand was provided for households in the lower income brackets to stimulate consumer spending in order to sustain economic recovery (South Africa. National Treasury, 2010, p.14). In this way taxes were used in an anti-cyclical manner.



The South African government's countercyclical response to stimulate growth was furthermore ensuring that spending levels on social and economic services were maintained although tax revenue was decreasing. The surplus funds for the year 2007/08 allowed South Africa to not have to raise taxes or cut spending in the short term and this decreased the economic and human costs of the recession. However, Laubscher (2013) warns that this will increase the tax burden and encourage dissaving in the future because increases in government spending to counteract the global crisis are not sustainable as there will be a need to increase revenue to support the budget.

### **3.4 SUMMARY**

This chapter discussed the major changes to the South African tax system through the different phases of the reforms. It also explained the economic rationale behind the reforms in terms of the standard principles of taxation. During the first phase, following the work of the Margo Commission, the most significant reform was the replacement of the GST with VAT. Fringe benefit also became taxable under PIT and marginal rates of PIT were decreased.

During the second phase, following the work of the Katz Commission, the most important reform was the establishment of SARS, which contributed greatly to administrative efficiency. Other major reforms included the further reduction of the marginal rate of PIT as well as the rate of CIT in order to conform to international tax practice and make the South African system more competitive. This was important because of brain drain and the need to attract foreign investment flows. Other reforms during the second phase included the introduction of the residence-based principle and CGT, which contributed to the economic efficiency of the tax system and also positively impacted on its effect on income distribution. Financial services became taxable under VAT, which further improved the equity of the system.

The last part of the chapter looked at whether the government achieved the goals as intended by the reforms. In most cases the administrative and economic efficiency as well as the equity of the South African tax system was enhanced throughout the two phases of reforms.

There should be further studies to analyse the impact of the changes in the tax structure of South Africa on the macro-economic variables like inflation and job creation. In particular, the effect on small business should be studied because small businesses were supposed to be encouraged by the tax system to employ more labour.



## CHAPTER 4

### GENERAL CONCLUSION

#### 4.1 CONCLUSION

This study focused on tax reform in South Africa since the 1990s, a period during which many countries made major changes to their tax systems.

Chapter One presented the problem statement, research question, objectives and organisation of the study. The main aims of the study were to provide a comprehensive overview of the most important changes to the South African tax system during the period following the Margo Commission's report up to 2010, to investigate the rationale behind the reforms, and to answer the question whether the intended objectives of the reforms were achieved.

Chapter Two provided the theoretical rationale behind tax reforms: administrative and economic efficiency; the impact of the tax system on income distribution; and to bring the system in line with international tax practise. In the case of developing countries tax systems are also reformed because new governments have new goals and need to attend to the wishes of the voters; because of declining aid flows; and, most important, because of globalisation. Due to globalisation and increased international tax competition, developing countries reform their tax systems not to lose capital and scarce skills. Policy-makers in developing countries have to also consider the following special features: generally weak administrative capacities, low per capita incomes and the importance of informal sectors.

Tax reforms in South Africa over this period occurred in two phases: the first being the period following the report of the Margo Commission, and the second that following the work of the Katz Commission. The most notable changes during the first phase were the introduction of VAT to replace the GST. This improved the revenue-raising capacity of the tax system as VAT is an efficient revenue collector due to its self-policing features. The increasing contribution of VAT since its introduction more than compensated for the decreasing contribution of trade taxes; however the fact that the VAT rate has stayed constant since 1993 is an indication of the unpopularity of the tax. Over the years, various studies have confirmed the regressive impact of the tax.

The establishment of SARS was a major institutional reform that contributed significantly to the administrative efficiency and revenue-raising capacity. This is evident from the increase in the collection of tax revenue over successive years. Other important reforms during the second phase were the introduction of capital gains tax, of the residence principle and of the decrease in MTRs of PIT as well as the flat rate of CIT. The first two of these reforms contributed to the broadening of the tax base, enhanced economic efficiency and improved the fairness of the system. The highest MTR of PIT was brought in line with the company tax rate and this decreased the possibility of tax arbitrage and the extent of avoidance, which contributed to decreasing the tax gap. The extent of evasion and avoidance by individuals is still high but according to the literature tax compliance by individuals has increased.

Significant tax relief to middle and lower-income earners over various years improved the impact of PIT on income distribution; however it did not improve the position of the really poor who are not liable for PIT. What was significant for the poor is that the tax threshold was adapted regularly over the years, which enhanced the equity of the tax system.

The phasing out of the secondary tax on companies together with the decrease of the rate of CIT increased the attractiveness of South Africa for capital-exporting countries. However, the effective tax rate on companies in South Africa was still relatively higher over most of the period, which negatively affected the competitiveness of the country to attract FDI flows. According to the literature, South Africa did not really succeed in attracting foreign investment over the years under study, even with the tax incentives in place. In addition, tax compliance by companies in South Africa is low.

In conclusion, experts warn against the increasing tax burden. The fact that it is likely to increase even further in future, to generate sufficient revenue to sustain higher levels of government expenditure, may scare off foreign investors and negatively impact the potential for further economic growth in future.

## **4.2 RECOMMENDATIONS**

1. To better evaluate the macroeconomic impact of the tax reforms further research should be encouraged on the impact of tax reforms on macro variables such as economic growth, inflation and job creation. The latter is particularly relevant in the case of small business because they were encouraged to create employment.

2. Further research should also be done on the relative cost of tax compliance as well as the tax gap.
3. As was recommended by the Katz Commission, the basket of zero-rated foodstuffs should be regularly reviewed.



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CBO *see* United States of America. Congressional Budget Office

CEEPA *see* Centre for Environmental Economics and Policy in Africa

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